When You Assume . . . . : Practical Advice for Avoiding the Latter Portion of That Adage When Assuming a Securitized Loan

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In this article, the authors provide buyers with tips and suggestions on closing an assumption of a securitized loan in an efficient and cost-effective manner.

With the ongoing turmoil in the capital markets worldwide, the daily media is filled with news about the state of the credit industry, particularly as it relates to real estate lending. Indeed, what was once the conversation topic of only those with a need to lend or borrow, or someone who provided services to those folks, is now regularly discussed in living rooms, barber shops and shopping malls across the country.

Deal flow from lenders of all shapes, sizes and stripes has slowed to a mere trickle of what it was over the past several years, and some lenders have closed the spigot completely. The securitizing or ''conduit'' lenders have been hit particularly hard by recent events, and pricing such loans has become virtually impossible. Lenders who last year, were moving capital into the real estate markets at a furious pace, are now experiencing their biggest challenge in 10 years.

So, one may ask, why talk about loan assumptions in the midst of all of the gloom in the capital markets. The answer is quite simple. While new money may be difficult to be had, an existing loan, which expressly permits assumption by a new borrower, as do most securitized loans, can essentially provide the debt that a prospective buyer may need to acquire a property. Granted, because the loan amount was established at the original loan closing, the buyer will not be able to obtain the higher amount that it might otherwise have requested. However, if the alternative is not closing the deal because new financing is not available, the loan assumption may prove to be a relatively attractive option.

The purpose of this article is to provide buyers with tips and suggestions on closing an assumption of a securitized loan in an efficient and cost-effective manner.

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What is an Assumption and Who are the Players?

In a nutshell, a loan assumption is as simple as it sounds. The buyer of a property that secures a mortgage loan *steps into the shoes* of the seller/borrower and assumes the obligations of the seller/borrower under the seller's/borrower's existing loan. In other words, not only does the buyer acquire the land and buildings, it also gets the loan and the related obligations of the borrower.

Although many types of loans contain assumption provisions, they are most commonly found in securitized loan documents.

Because of the tremendous expansion of conduit lending over the past decade, most borrowers are familiar with the basic concepts and the parties involved in a securitized loan. However, to set the stage for our discussion, we will identify the primary parties involved in a loan assumption.

Who is the "Lender"?

Pools of securitized loans are established and serviced pursuant to ''Pooling and Servicing Agreements.'' The Pooling and Servicing Agreement governs all aspects of the administration of the loans that are securitized in a particular pool.

The loans in a pool of securitized loans are purchased from the lenders that originated those loans by a trust created solely for the purpose of holding those loans. So, technically speaking, that trust is the lender. However, it is important to note that the trust has no raison d'etre other than holding the loans and, moreover, has no employees to deal with the loans. Rather, day-to-day loan issues are managed, or ''serviced,'' by one or more ''servicers.''

Who is the "Servicer"?

The most common division of labor on the servicing side is between a ''Master Servicer'' and a ''Special Servicer.'' Generally speaking, the Master Servicer provides servicing when things are good (read, the loan is not in default), and the Special Servicer handles the loan when things are bad (read, the loan is in default). There are many variations on this, but for purposes of this article, we will follow that model, with one important exception regarding the Special Servicer, that we will discuss below.

Assumption Scenario

With that introduction, let's jump into a loan assumption using the following simple hypothetical situation as the basis for our discussion:

Seller owns commercial real estate known as Blackacre. When Seller acquired Blackacre for $15,000,000, it borrowed $9,000,000 from Lender (the ''Loan''). The Loan is a typical non-recourse loan, secured by a mortgage that encumbers Blackacre. Seller's principals provided a typical guaranty of the non-recourse carve-outs.

Buyer and Seller have entered into a purchase agreement pursuant to which Buyer will buy Blackacre from Borrower for $20,000,000, Buyer will assume the obligations of the Loan, and Buyer's principals will provide a new carve-out guaranty. The Loan provides a typical one-time right of assumption.

First Steps—The Approval Process

Promptly after the purchase agreement is signed, Buyer should request from Seller copies of all of the loan documents and any other materials related to Blackacre and the Loan that may be in Seller's possession. Theoretically, the Seller will be in as good, if not better, a position as any other party involved in the loan assumption to advise Buyer on the history and terms of the Loan.

Buyer should review carefully the terms and conditions of the loan documents, particularly the requirements for the assumption of the Loan. At the risk of stating the obvious, the Buyer that carefully reviews, or has its counsel review, the loan documents will be best able to efficiently close the assumption of the Loan. Remarkably, many buyers do not review the loan documents before contacting the Master Servicer in connection with a loan assumption. Unfortunately, the same is true with respect to many routine servicing matters, but that is a topic for another article and another day.

Upon receiving an inquiry about a loan assumption, the Master Servicer will send to Buyer an information request package that typically includes a timeline for the assumption process and describes the requisite deliverables and the fees that will be payable. Needless to say, the Master Servicer will be able to process the assumption request more quickly and efficiently if Buyer submits a complete and accurate application package.

Start to finish, beginning with Master Servicer's receipt of the complete application package, the assumption process generally takes about eight to ten weeks. This presumes that the Master Servicer has received a complete package and that there are no unusual, or undisclosed, issues in the deal. If that presumption is not true, more time may be required. Accordingly, it is important for Buyer to plan ahead, especially if there are any specific time constraints, such as a 1031 exchange deadline. The Master Servicer generally will work with Buyer to meet its deadlines, but cannot be responsible for ensuring that Buyer meets those deadlines. Most Master Servicers have a large volume of loan assumptions in their pipeline at any given time, so it behooves any buyer to timely submit a complete application and remain proactive.

The assumption application will require Buyer to make certain deposits with the Master Servicer, including a deposit for the Master Servicer's costs and expenses. The application may also contain indemnities in favor of the Servicer in order to proceed with the assumption process. Buyer may also be asked to identify its authorized representatives and to indicate whether the assumption involves a 1031 exchange or other timing sensitivity, which may affect the timing of the assumption process.

The Master Servicer will likely require that Buyer

provide the following documents as part of the application package:

(i) formation documents, including those of Buyer's partners or members, as applicable;

(ii) an organizational chart reflecting Buyer's equity/ownership structure;

(iii) a contact list;

(iv) resumés for each of the proposed new guarantors and principals who control the management of Buyer;

(v) the management agreement for the property and a resumé of the property manager;

(vi) the fully executed purchase agreement;

(vii) a current preliminary title report for the property;

(viii) a completed W-9 tax form;

(ix) any 1031 documentation that clearly states the 180 day exchange completion date;

(x) current financial statements, bank and investment account statements, lists of owned real estate, and income tax returns for Buyer and its key principals;

(xi) references and credit check authorizations;

(xii) cash flow statements and operating statements for the property for the most recent fiscal year-end, current year to date, and 12 month projected;

(xiii) a current rent roll; and

(xiv) a list of recent comparable sales and leasing transactions in the local area real estate market comparable to the property.

Buyer should be aware that the Master Servicer may reassess existing escrows and reserves in light of current market conditions and/or if there is a potentially increased risk of tenant rollover. Similarly, if the proposed new guarantor does not have the financial strength of the outgoing guarantor, the Master Servicer may require that Buyer or the new guarantor post a letter of credit or other collateral in order to address that deficiency.

Master Servicer will run credit checks, litigation searches, and OFAC reports on Buyer, guarantors, and key principals. As an aside on the issue of searches, with respect to the entire assumption approval process, but particularly with respect to litigation and credit issues, full disclosure and honesty are the best policy for all parties involved. Time is added to the process if the Servicer has to come back to a buyer repeatedly for revisions or explanations, and it is a waste of everyone's time (and money) if the Master Servicer ultimately declines an assumption application based on undisclosed credit issues or litigation that could have been disclosed at the start of the process.

Special Servicer Approval

Here is the notable exception to the earlier statement that the Special Servicer only gets involved when things are bad. Even when all is well, most Pooling and Servicing Agreements require the Master Servicer to obtain the consent of the Special Servicer before the Master Servicer may authorize a loan assumption. The logic that drives this requirement is essentially twofold: (a) the investors want an independent, third party review of the Master Servicer's underwriting and approval process, with the Special Servicer providing that review; and (b) Special Servicers often own the lowest rated tranches of commercial mortgage-backed securities (''CMBS''), which puts them in the first loss position. In other words, if the Master Servicer makes a bad decision about a loan assumption and, as a result, the pool sustains a loss, it may be the Special Servicer that feels that pain in its pocketbook.

After the Master Servicer has reviewed the loan assumption and determined that the transaction may proceed, the Master Servicer will prepare a recommendation of approval that it will submit to the Special Servicer. Typically, the Pooling and Servicing Agreement will give the Special Servicer five to 15 days to respond to the Master Servicer's submittal. Yes, it does take that long for the Special Servicer to approve the deal, and no, buyers may not talk to the Special Servicer. If Buyer has questions about the status of the Special Servicer's approval, those questions must be channeled through the Master Servicer.

A goal of securitized lending is efficiency, but that does not mean that requests can be processed immediately. The purpose of the approval requirements is to require the Servicers to respond quickly, but to also give them enough time to properly evaluate the request. The point here is to again emphasize the importance of timely submittals to the Master Servicer and timely responses to requests for additional information.

If the Special Servicer approves the Master Servicer's recommendation, the Master Servicer will issue an approval letter to Seller and Buyer that sets forth the Lender's conditions for closing. The Master Servicer will then engage legal counsel to document the transaction. If Buyer is especially concerned about timing, Buyer may request that the Master Servicer engage its counsel early. The Master Servicer will, however, want assurances from Buyer that the Master Servicer's expenses will be paid by Buyer and/or Seller, regardless of whether the approval is ultimately issued.

Rating Agency Approval

Certain loans also require the Master Servicer to obtain the consent of the Rating Agencies. Typically, only the largest loans in a given pool (e.g. the top 10 in the pool, or those that make up more than two percent of the pool balance) require Rating Agency approval.

The issue here is, you guessed it, timing. The Rating Agencies are very responsive, but they too need time to review and respond. Moreover, because of the

volume of requests to which the Rating Agencies must respond, the Rating Agencies typically do not begin their review until a complete package is submitted. This package usually requires a REMIC tax opinion, which the Master Servicer's counsel may prepare, and the dreaded non-consolidation opinion that Buyer's counsel must provide. A discussion of these opinions is outside the scope of this article, but Buyer must be aware that these opinions may be required.

Now that our hypothetical Master Servicer has obtained approval for the assumption of the Loan, let us turn to actually documenting and closing the loan assumption.

Documenting and Closing the Loan Assumption.

Special Orders . . . May Upset Us

In a loan assumption, Buyer and the Buyer's principals are stepping into the shoes of the Borrower and the existing guarantor. From the perspective of Lender, the Servicers and the investors who have purchased the CMBS bonds, the terms of the loan are, and will remain, in every respect, final. Those parties cannot make the deal better, nor would they want to modify the loan to their detriment.

The point here is that Buyer may find provisions in the loan documents that it does not like and it may want to change those provisions. The short response to this situation is that although Buyer may wish it could change those provisions, there is no reason for Lender to do so, and the answer is usually going to be no. Moreover, because of the REMIC rules under the Internal Revenue Code, Lender may be completely restricted from making the modifications Buyer is proposing, no matter how much better the deal could be made for all parties. This is where Buyer needs to recall the famous maxim of loan assumptions: ''Grant me the serenity to accept the things I cannot change. . . .''

That said, there are two areas where Servicers are willing to consider modifications.

The first place where modifications are possible is where the loan documents contain an obvious error or where changes are needed to conform the documents to the new facts (*e.g.*, the name of a new property manager or key principal). A point to bear in mind here is that the Master Servicer will not review every provision of the loan documents in connection with your loan assumption. Rather, Buyer and its counsel must review the loan documents and highlight for the Master Servicer any errors or provisions where conforming changes are needed.

The other area where the Master Servicer may consider a modification is with respect to the equity transfer provisions in the loan documents. Typical loan documentation restricts the types of equity transfers that may be made; another important reason why Buyer and its counsel must read the loan documents. These provisions typically restrict both direct and indirect transfers, which means that by assuming the loan obligations, Buyer may unwittingly subject its equity owners to restrictions on their ability to transfer equity interests. These types of restrictions can be particularly burdensome to publicly traded companies or funds where investors are regularly coming and going.

If the loan documents contain restrictions on transfers that will not work with Buyer's equity structure or business model, Buyer should come to the Master Servicer early and be very specific about the necessary modifications to those provisions. The Master Servicer will typically be flexible with respect to certain types of modifications, such as the ability to trade shares of an upper tier entity on the public markets, provided such transfers do not result in a change in control. Similarly, certain types of transfers for estate-planning purposes or other intra-company transfers may be permissible so long as the guarantors/key principals remain in control of Buyer and continue to own certain minimum percentages.

Again, the critical issue is to submit the request early, so the Master Servicer can consider the request as part of the assumption underwriting process and include the request in the recommendation write-up that the Master Servicer will submit to the Special Servicer and, if applicable, the Rating Agencies.

Some Thoughts on Organizational Documents

The single-purpose entity (''SPE'') is one of the hallmarks of securitized lending, and one of its most basic requirements. Although the SPE requirements are not difficult to comply with, this area is one in which Buyer may find itself wasting tremendous amounts of time and money.

It is the rare set of conduit loan documents that does not contain detailed requirements for the structure of the borrower. The SPE provisions specify which entity, or entities, must be a single-purpose entity and what provisions must be contained the organizational documents for such entity or entities. Thus, at the risk of stating the obvious once again, before Buyer contacts the Master Servicer, it should obtain copies of the loan documents and read them, particularly the SPE provisions.

It is also the unusual set of circumstances in which the Master Servicer will permit Buyer to use an existing entity as the new ''borrower.'' One of the primary purposes of the SPE is that the Lender's collateral, and the operation of that collateral, can be isolated from everything else that a borrower's sponsors and affiliates are doing and that they may have done in the past. The prior acts and liabilities, both actual and potential, of an existing entity would frustrate that purpose. Accordingly, if the loan documents require an SPE, that

entity must be newly-formed. Merely modifying the organizational documents of an existing entity to conform to the requirements of the loan documents of the Loan will not be sufficient. Accordingly, if the loan documents require Buyer to be a single-purpose entity, Buyer should form a new entity and comply with the specific terms of the loan documents.

Buyer and its counsel may have a preferred form of operating agreement or limited partnership agreement that contains SPE provisions that differ from the provisions contained in the documents that govern the Loan. While the substance of the provisions may not be materially different, Lender's strong preference, if not absolute requirement, will be that the SPE provisions in Buyer's organizational documents match the provisions in the loan documents verbatim. Remember, Buyer is stepping into the shoes of Seller with respect to all aspects of the Loan, including the SPE provisions. Moreover, because the substance will not differ meaningfully, there is likely no reason for Buyer to debate with the Master Servicer about the relative merits of these provisions. Debate adds cost, and the goal is to close the assumption efficiently.

Single Member Limited Liability Companies

Returning briefly to the topic of the requirement that Buyer be newly-formed, Buyer may want to use an existing entity so that it may take advantage of a tax deferred exchange under Section 1031 of the Internal Revenue Code. The Code requires specific commonality between the selling entity (i.e., Buyer in our hypothetical, as the seller of other property that will generate the proceeds to purchase Blackacre) that is seeking to defer capital gains taxes and the entity that will acquire the new property in the exchange (i.e. again Buyer, as the purchaser of Blackacre). The requirements of the Code and Lender's requirements can, however, be satisfied by the formation of a single-member limited liability company, of which the selling entity (i.e. Buyer's existing entity) will be the sole member. Because the single-member limited liability company is a ''disregarded entity'' under the Code, the requirements of Section 1031 should be satisfied, although Buyer should always confirm this with its tax counsel. Because the entity will be a newly-formed entity, Lender will be happy too.

An additional advantage of Buyer using the single-member limited liability company is presented if the loan documents require multiple levels of single-purpose entities. For example, the loan documents may require a limited partnership borrower to have a corporate general partner that is also a single-purpose entity. Similarly, if the borrower is a limited liability company, the loan documents may require that the borrower have a corporate managing member that is a single-purpose entity. The loan document requirement for this second level of single-purpose entity may be avoided if Buyer uses a qualified single-member limited liability company. In other words, by forming a qualified single-member limited liability company, an SPE general partner or managing member will not be necessary.

The Master Servicer will generally approve a single-member limited liability company as the borrower, subject to satisfying the standard single-member limited liability company requirements, even if the loan documents do not specifically reference such a limited liability company as a permissible borrowing entity.

A few words of caution about the use of single-member limited liability companies:

- Because of certain favorable aspects of Delaware law, the general Rating Agency requirement is that single-member limited liability companies be formed in Delaware. Before forming a single-member limited liability company in a jurisdiction other than Delaware, check with the Master Servicer.
- Typically, in addition to its single member, the single-member limited liability company must have a ''springing'' or ''special'' member whose purpose is to ensure the continued existence of the entity if the single member files for bankruptcy protection or dissolves. Ask the Master Servicer to provide its specific requirements with respect to this issue.
- Depending on the amount of the Loan, the Master Servicer may require Buyer to deliver certain Delaware legal opinions with respect to the single-member limited liability company. The required opinions are quite specific and a discussion of these opinions is outside the scope of this article. If a single-member limited liability company will be used, ask the Master Servicer if the Delaware opinions will be required.

Title and Survey

Lender will want assurances that, after the closing of the loan assumption, the lien of its mortgage or deed of trust will remain in first priority and that such security instrument remains insured under the Lender's policy of title insurance. Typically this is accomplished by the delivery of an endorsement to the Lender's title policy. The ability of Buyer's title insurance company to issue that endorsement presumes that Buyer's insurer is the same as the company that issued the Lender's original policy. If those title companies are not the same, the new title company will be required to issue a new lender's policy of title insurance.

If a new policy is necessary, the Master Servicer will require that the new loan policy be identical to the policy that was issued at the closing of the Loan, including all of the endorsements that were part of that original policy. Buyer can speed this process by promptly requesting a copy of the Lender's original

policy from the Master Servicer and delivering that policy to Buyer's title company.

Generally, the Master Servicer will not require an updated survey in connection with the assumption, the presumption being that nothing should have physically changed with respect to Blackacre. If, however, a new lender's policy of title insurance is required as described above, the Master Servicer will generally need a new survey to enable the title company to issue the survey-related endorsements to the new policy. Obviously there will be cost associated with the review of the survey by the Master Servicer's counsel. Accordingly, if possible, Buyer should use the same title company that issued the original Lender's policy, thus eliminating the need for Master Servicer review of a new survey and likely saving Buyer time and money.

Some Other Hot Button Items

Guarantor Liability

In negotiating loan assumption documents, Buyer may ask that its liability under the Loan and, perhaps more importantly, the liability of the new guarantor, commence as of the closing date of the loan assumption. From the perspective of Buyer, this is a perfectly reasonable request because Buyer had no control over what may have happened while Seller owned Blackacre and was the borrower under the Loan. Unfortunately, Lender generally cannot accommodate such a request. Rather, Lender will require that the liability of Buyer and the new guarantor looks back to the closing of the loan.

The issue for Lender is that, after the loan assumption closes, Lender will have no further contact or interaction with the outgoing borrower and guarantor. Moreover, in the event of dispute or other issue with the Loan, Lender will not want to be required to determine whether such liability was the responsibility of the old borrower or the new borrower; this is especially true in the case of environmental issues where determinations of liability can be particularly thorny. Rather, Lender will look to Buyer and the new guarantor, without regard to which parties on the hook before the loan assumption closed and regardless of whether the Seller and the original guarantor may have been released. Accordingly, Buyer should consider addressing this in its purchase agreement with Seller and obtaining an indemnity from Seller that will survive closing.

Lender Representations

Another common request is that Lender represent to Buyer that there is no event of default under the Loan. Also a reasonable request, but yet another example of something that Lender will likely be unwilling to provide.

At the risk of sounding ''Alice In Wonderland''-esque, the issue here is that Lender . . . is not really a lender . . . at least in the sense of an operating company that is in the business of lending. In other words, the securitization trust is the *lender* in that it is the owner of the Loan, but the trust has no other involvement with the Loan. The trust is simply a legal fiction, without employees or existence other than on paper, that was created only to facilitate the securitization of the Loan. The day-to-day business of administering the Loan is handled by the Master Servicer, that has only the information about the Loan that was provided to the securitization trust by the lender that originated the loan. Moreover, loan documents will not require lenders to provide such a representation, and the Pooling and Servicing Agreements do not obligate Master Servicers to provide such representations. Accordingly, because Lender is not really a true lender, and because the Master Servicer has only relatively limited knowledge about the Loan, the Master Servicer is generally unwilling to provide an absolute representation, or even a knowledge-based representation, that there is no default. Buyer must, therefore, rely on its own due diligence and the representations provided by Seller in the purchase agreement with respect to the issue of whether the Loan being assumed is in default.

Buyer may take some comfort in the fact that if the Loan were in default, and the Master Servicer had knowledge of that default, the ''servicing standard'' under the Pooling and Servicing Agreement to which the Master Servicer is subject would preclude the Master Servicer from permitting the assumption to close. Additionally, if the Master Servicer has knowledge of a default, it will want that default resolved before closing the loan assumption.

Insurance and Impounds

Insurance is a critical component of the loan assumption that too often gets left to the very end of the transaction. At the outset, Buyer should ask the Master Servicer for Lender's insurance requirements and forward those requirements to its insurance broker or consultant. Additionally, if the Master Servicer does not provide the name and contact information for its risk manager, Buyer should request that information, so that the folks who speak the same language can start discussing insurance early.

Most securitized loans have multiple impounds, escrows or reserves. Typical reserves are taxes, insurance, capital improvements and tenant improvements. Buyer and/or Seller may ask that Lender release those reserves to Seller at the closing of the loan assumption and have Buyer replenish those reserves at closing; however, this is unnecessary and not the preferred method of dealing with reserves.

Rather than physically moving funds, the Master Servicer will simply maintain the reserves as they are, and Seller and Buyer will address the reserves as

credits on the purchase and sale settlement statement. The Master Servicer will provide the balances of these accounts so that the parties can properly prepare the settlement statement.

Counsel

The need for competent legal counsel with relevant experience is important in all facets of commercial real estate transactions. It is especially important when working with a securitized loan. While the Master Servicer and its counsel are always willing to assist Buyer and its lawyers, costs can increase dramatically when the Master Servicer's counsel spends time educating Buyer's counsel or responding to requests that more experienced counsel would not have submitted in the first place.

Conclusion

Efficiency is one of the primary goals of securitized lending: efficiently closing the loan; efficiently slicing up the risk of the loan and placing the relative risks who have the appetite for that risk; and efficiently administering the loan after closing. With respect to administering the loans, Servicers are committed to that goal of efficiency.

To achieve that goal of servicing efficiency in the context of loan assumptions, Buyers need to cooperate with the Servicers from early in the transaction and throughout the process. That cooperation is provided by: reading the loan documents carefully; promptly submitting a complete application, including any special requests; making full and accurate disclosure; understanding the limitations of what a Servicer can and cannot do, both in terms of revising documents and with respect to timing; and communicating with the Servicer throughout the process. Bearing these suggestions in mind, Buyers are usually the masters of their own destiny in the closing of a loan assumption. Provided the Servicers are provided with the documents and information they require, and barring any last minute surprises, Servicers can generally move quickly, so Sellers and Buyers can close their deals quickly, and get back to the business of successfully operating their properties.