A Miranda Warning for Potential Conduit Borrowers

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WITH ALMOST A DECADE OF SERIOUS CONDUIT lending under our belt, you could be forgiven for thinking that most borrowers would have a fairly clear understanding of the workings of the commercial mortgage-backed securities (CMBS) sector of the commercial mortgage lending business. Mortgage bankers have cycled through nearly all their borrowers and loans over the last decade, refinancing many via a conduit.

The Federal Reserve calculates that nearly one-fifth of all outstanding commercial mortgage debt is securitized—about $281 billion, according to New York–based Morgan Stanley Dean Witter.

Even with all that CMBS experience, borrowers continue to bombard mortgage bankers and loan servicers with impossible postclosing requests and breathtakingly naive questions. Confusion about the servicing process still appears widespread. Why is this?

We have concluded there are three possible explanations: Borrowers do not read their loan documents, ever; borrowers do not have long memories; and mortgage bankers and conduit lenders are not doing a very good job explaining the requirements and ramifications of the CMBS structure to borrowers before loans close.

Avoid boxing your borrowers into an ill-fitting structure for their needs by reading this list of warnings. Commercial MBS structures can be rigid and unforgiving for some borrowers—don't let it come as an unwelcome surprise.

Although there is some evidence in support of the first two propositions, we have chosen not to bite the hand that feeds us and will instead focus on the third hypothesis—that the primary culprit is a communications failure. Indeed, informal industry reconnaissance suggests that not only is this true, but many mortgage bankers and loan originators are ill-equipped to effectively communicate CMBS servicing realities to their customers.

Moreover, some in the loan origination process may look at CMBS servicing realities with an ill-conceived "don't ask, don't tell" policy. But whether from ignorance or a wrongheaded concern that an informed borrower is a missed opportunity, not educating the borrower is a bad idea. First, many borrowers already have a visceral, negative feeling about CMBS. Education and demystification of the CMBS process can only improve your chances that these borrowers will not reject a CMBS lending source out of hand. In addition, if a borrower gets a nasty surprise after closing, that borrower is unlikely to feel kindly toward the lender or mortgage banker who got him or her into the mess in the first place. It is absurdly shortsighted to trade one deal for continued borrower enmity.

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The reality is that CMBS lending can, in many cases, provide a substantially better execution than competing portfolio products. That's news that is easy to tell, and the industry is reasonably good at telling it. But there are also servicing restrictions attendant to the structure that make it ill-suited for some transactions. It behooves professional originators or bankers to be educated about CMBS servicing and be forthright with their borrowers.

To help lenders and mortgage bankers educate the borrowers, we propose that every borrower be read, before closing, his or her CMBS Miranda Warning. Once the banker determines that a loan may "fit" in the conduit box (terms, loan-to-value, debt coverage, rate-lock requirements, etc.), the Miranda Warning will help determine whether a conduit execution is right for the borrower.

The Miranda Warning

WARNING NO. **1**. *If you pursue this securitized loan product, you may be required to meet a series of complex and sometimes expensive requirements regarding the need for a new, single-purpose entity; adoption of separateness covenants; employment of independent directors; and delivery of a nonconsolidation opinion.*

Depending on the size of the loan, some or all of these criteria may be imposed. Generally, the larger the loan, the more of these requirements will be applicable. Separateness covenants can have a real (albeit generally mild) impact on operating efficiency. These are binding legal agreements to operate the borrower in a manner separate and distinct from any affiliates.

The need for a new entity can either be a modestly expensive nuisance or a real headache if the local jurisdiction imposes a tax triggered by the transfer of the property into a fresh entity. Including independent directors in the structure is modestly expensive and, like the requirement for separateness covenants, will impose limited operating restraints on the borrower. Nonconsolidation opinions can be expensive to give, and not all lawyers are equipped to give them—potentially necessitating retention of separate special counsel.

WARNING NO. **2**. *There will be several companies servicing your loan with whom you probably have no relationship, and these new servicers will actually read and follow the letter of your loan documents.*

Most borrowers are used to their local commercial mortgage banker staying in the deal to handle requests and customer service once the loan is closed. In a securitized loan, the borrower's mortgage banker is likely to have little—if any—decision-making authority on servicing issues, and may have no servicing role at all.

In portfolio transactions, there is a complex, symbolic relationship between borrower and lender-servicer in which future lending business plays an important role in the servicing relationship. In CMBS transactions, there is not one servicer but as many as three, including a sub, master and special servicer. (There are four, if you count the "operating adviser"—a bondholder representing the lowest-ranked class of bond, who may have a say in servicing matters.) The prospect of new borrower business is not as important to the upstream (master and special) CMBS servicers and, indeed, the servicers' contractual duty of care expressly prohibits giving weight to any such consideration. In addition, servicers in CMBS transactions must service the loan precisely in accord with the loan documents. If the documents say you must provide a rent roll every month, you can actually expect someone to call for it and insist it is delivered.

In addition to reading and enforcing the loan documents, the servicers will service the loan in precise conformity with another document, to which you are not a party—commonly known as a pooling-and-servicing agreement—that governs the servicing of the pool of loans in which your loan will be included. The pooling-and-servicing agreement is a complex document designed to meet rigorous structural features needed to conform with the real estate mortgage investment conduit (REMIC) tax requirements for pooling the loans. It also helps to otherwise balance the interests of bondholders, issuers, servicers and the like. For good or ill, it provides, in enormous detail, what the servicers can do and how they do it.

Finally, it is important to remember that each servicer has a separate interest in the pool, and each may have a distinct perspective and approach to servicing issues. As these entities interact, there can be disputes, delays and inefficiencies.

WARNING NO. **3**. *The bondholders can actually use that useless "back 40" included in the mortgaged property, and you may not be able to have that parcel released for sale*

in a few years as you had planned.

This comes up time and again. An opportunity to sell or develop a relatively (from the perspective of the underwriting of the loan) valueless out parcel, frontage piece or adjacent sliver of land presents itself a year after the loan closes. In a portfolio loan, getting a release of such a valueless parcel may be relatively easy. However, releasing collateral—any collateral—is problematic once the loan is in the securitized structure.

CMBS master and special servicers are limited in their ability to release (or encumber) property, which is security for the loan. It may be possible to obtain the release of unimproved land with a value less than 10 percent of the value of the entire parcel (an industry rule of thumb), but, even in that case, it will take time and cost money. A REMIC opinion is likely to be required (see Warning No. 7).

For larger parcels, it is effectively impossible, short of paying off the whole loan (which itself is problematic in many instances). A better alternative is to address this issue before the loan closes, because if the loan documents specifically contemplate the release of an out parcel and define the circumstance under which that release will occur, out parcels of any size can be released and the process will be much more efficient and expeditious.

WARNING NO. **4.** *You may not be able to develop Phase 2 and obtain the necessary cross-easements until after you pay off the loan.*

This is common on multifamily and retail properties. A borrower wants to develop a large apartment community or retail center in phases, financing each contiguous parcel along the way. As land and buildings are added, it is inevitable that easements must be granted by the owner/borrower of Phase 1 to the new borrower/owner of Phase 2 for access (ingress/egress), utilities, amenities, parking and the like.

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In a CMBS structure, the two borrowing entities must be distinct and cannot be combined or cross-collateralized once the Phase 1 loan is securitized. Because each phase has to stand on its own, it can be somewhat difficult, time-consuming and sometimes modestly expensive to obtain master/special servicer consent to easements. As with the problem with releases, the key here is to get as many of the needed easements in place (or agreed to) prior to the Phase 1 financing.

WARNING NO. **5.** *Don't even think about adding 20,000 square feet to that Food Lion.*

Where property additions and expansions are quite common in the portfolio loan environment, they are difficult and can be impossible once the loan is wrapped in a REMIC. A keystone of REMIC treatment is that the pool of loans is static. If a loan is deemed exchanged for a new loan (Section 1001 of the Internal Revenue Code governs this), this static principle is violated and the pool becomes subject to a second level of federal income taxes. This is bad.

> The securitized market is serious about data requirements.

A material modification of the improvements of the property may constitute such exchange of an old loan for a new loan under the code and, therefore, be impermissible. While some additions (or deletions) under some circumstances are possible, a process of complex review by the servicers and delivery of a REMIC opinion will be triggered.

WARNING NO. **6.** *You will be bugged every 90 days for quarterly operating statements and rent rolls. (By the way, can you use our form—it's better—and please send the data to our Web site or e-mail it to us in comma-delimited format?)*

It should come as no surprise that the lenders want information about the performance of their mortgaged property during the term of the loan. However, in traditional portfolio lending, data requirements are often limited and the requirements are often honored more in the breach than otherwise.

The securitized market is serious about data requirements. As mentioned earlier, a servicer will, in fact, enforce the provisions of the loan documents regarding the delivery of data and may even, under certain loan documents, be entitled to impose a fee for the borrower's failure to deliver data. Ultimately, you may be declared in default for the failure to deliver data. Read the data requirements of the loan documents carefully. The lender is serious. Can you comply with your existing systems? Can your systems be upgraded? Do you want to give that data?

WARNING NO. **7.** *You will be asked to provide a REMIC opinion when your loan gets modified. (Can you guess who pays for it?)*

Returning to a common theme of these warnings, pools for which a REMIC election is made must be static. When a modification of the terms of the loan documents is proposed, a determination must be made by the servicer that under the Internal Revenue Code the change is not so substantial as to constitute an exchange of the old loan for a new one. This would mean the pool is not static. As mentioned earlier, violations of the REMIC rules have catastrophic results that, to say the least, will annoy the bondholders and probably occasion substantial liability for the servicer.

The pooling-and-servicing agreement (the document that governs the servicer's world) provides that servicers are entitled to rely on tax opinions rendered by nationally recognized

tax counsel. If the servicer obtains an appropriate opinion from tax counsel, it washes its hands of liability for violation of the REMIC rules. Oddly enough, this has occasioned a robust appetite for tax opinions. In practice, this means tax opinions are required in virtually any transaction in which the underlying loan documents may be modified in any respect. Generally, REMIC opinions are not difficult for expert tax counsel to prepare, but they are neither free nor always timely.

WARNING NO. **8.** *Be prepared to transfer a substantial portion of your liquid assets to the loan servicer in the form of holdbacks and monthly tax, insurance and replacement reserves.*

Conduit loans are often high-leverage. Underwriting has become more homogenous under pressure from the rating agencies and broad reserves have become common. Insurance, taxes, lease-rollover risk, deferred maintenance and capital improvements may all attract a reserve requirement. These are real (cash) reserves and not merely underwriting charges. While horse-trading is common and the number and magnitude of reserves responds to market conditions, it's fair to say that CMBS structures are more likely to see real reserves. This is particularly true for substantial risks such as major rollover problems or material deferred maintenance. A promise to find and fix may simply not cut it. Borrowers should be made aware of these cash requirements early on.

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WARNING NO. **9.** *If the deal was for the Walgreens, you'll not be able to swap for that Eckerds next year. Bondholders don't barter.*

Returning, once again, to a regrettably common theme through these Miranda Warnings, REMIC pools are static. A borrower cannot substitute one property for another, even if the substitute property is arguably more valuable. Let's make that even clearer. You can't substitute even if everyone agrees the other property is more valuable.

In the traditional portfolio market, it's possible for a borrower to work with its longtime lender and agree to swap properties into a deal. It cannot be done in a REMIC structure. It is possible to agree in the loan documents in advance for substitution. But it is extremely awkward and rather limiting. Generally speaking, it is not done except in very unusual circumstances.

WARNING NO. **10.** *If you are planning to sell your property soon and want to transfer your mortgage pursuant to an assumption, better plan on starting early.*

Many conduit programs allow a one-time transfer of the property pursuant to an assumption of the mortgage by a qualified buyer with the consent of the lender (master servicer). That's the good news. The bad news is that obtaining consent is likely to be somewhat expensive and time-consuming, because of the layering of servicing and the additional fees tacked on by servicers, rating agencies and third-party-report vendors.

The general underwriting rule is that the new borrower must have at least as much experience, financial wherewithal and positive credit as the original borrower (even though it is a nonrecourse loan). Your loan documents will govern whether the loan documents can be assumed. While many allow for a one-time transfer, the variation in approach on this point is substantial.

Remember that your servicer will do exactly what the loan documents say. If the loan documents do not permit assignment and assumption or do not permit assignment and assumption of the type you desire or to the party to whom you want to sell the property, you are out of luck.

WARNING NO. **11.** *You really ought to know what defeasance is. If you don't—ask. It's better to appear stupid (you are not, actually) and ask, than to prove it by not asking.*

This is the time bomb that is usually glossed over when the loan terms are presented to the borrower. Almost all conduit loans now require the loan to be defeased rather than paid off with a prepayment fee or yield maintenance once the lock-out period expires. Defeasance means that, in lieu of paying off the loan, the borrower must deposit Treasuries or equivalent securities in an entity in an amount sufficient to meet each and every one of the payment obligations under the original promissory note. Once this is done, the mortgaged property is released.

If the securities pay a higher return than the coupon, the loan could be defeased at a discount. Regrettably, this is unlikely to happen anytime in the near future. Consequently, defeasance is more expensive than yield maintenance. Why? Because not only must the borrower purchase bonds with a face value in excess of his or her mortgage note to match cash flows (effectively, yield maintenance), but the borrower must fork out transaction fees to attorneys, rating agencies, brokers, accountants, trustees and servicers to execute the substitution of collateral.

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WARNING NO. **12.** *This may be the last time you will be able to borrow money on this property until your grandchildren are in college.*

This, of course, assumes the borrower currently has no children (OK, we overstate a bit). Most conduit mortgages do not allow further encumbrances without the consent of the

lender. Not only is impermissible further encumbrance a default, but it's likely to trigger personal liability to the loan sponsor under the nonrecourse carve-out provisions and sponsor guarantees that are typical of many programs.

While additional encumbrance may be permitted with servicer consent, it is unlikely to be provided (since it is usually hard to see how it will help the bondholders, which is the key question under the pooling-and-servicing agreement), and virtually all such requests need the approval of the applicable rating agencies. This, at the very least, will cause delay and cost money.

The right to encumber the property with subordinate financing can be agreed to up front, but is rarely something the lender will be keen to embrace. Certain types of mezzanine financing can be used to effectively further encumber property, but even these solutions are complex and expensive.

So these are the Miranda Warnings for your borrowers.

But let us leave you with your lender's Miranda Warnings as well. There is just one, so it's not hard to remember: If you fail to give your borrower his or her Miranda Warnings, you will be punished.

Borrowers who unwittingly find themselves stuck in inflexible structures with real business problems have no sense of humor and may be vindictive. The short-term benefit of allowing an unwary borrower to do an ill-fitting securitized deal today is not a good trade for the long-term enmity of a really angry customer tomorrow.

Identify the problems, see if they can be addressed (and some of the solutions are described earlier)—but if the borrower's concerns with the structure are intractable, move on and keep the customer. **MB**

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Authors' disclaimer on Miranda Warnings: Loan originators should not misinterpret this article. This is not about scaring borrowers into alternative sources of financing. The conduit/CMBS execution has and will be a robust funding source for our industry, but it is not the ideal structure for all deals. Our goal is to provide a checklist of questions to help loan officers determine if a conduit loan and the CMBS structure is the correct source of financing for their borrower *over time.* However, we recommend that loan officers may want to rephrase the questions depending on their borrowers' sense of humor.

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