“Danger Will Robinson!”

Introduction to Securitized Lending:

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Introduction to Securitized Lending

1. Who are the “Key Players”?

2. What is a REMIC, and why should I care?

3. *I've got a feeling we're not in Kansas anymore* – how securitized loans really are different.
Conventional Mortgage Financing Loan Process and Payments:

Origination START TO FINISH takes about 2 months

Traditional Loan Structure
What’s different in Securitized Loans:

Key Players in CMBS

• Borrower

  - must meet specific lender requirements for organization and structure – commonly referred to as a Single Purpose Entity, Special Purpose Entity, Bankruptcy Remote Entity or Special Purpose Bankruptcy Remote Entity (the “SPE”)

  - generally structured with the single purpose of owning and operating a single asset. This structure insulates the collateral from exposure to some risks of bankruptcy.
Key Players

- **Lender (Loan Originator)**
  - Makes loans secured by first priority liens on real property
  - Due diligence focuses on assessing borrowing entity structure (including entity guarantors), performance of collateral, and mitigating factors
Key Players

• Depositor
  – Buys the loans from the loan originators.
  – Sells the loans to the Trust in exchange for certificates issued by the Trust. Certificates are then sold to various third party investors.
Key Players

• The Trust
  – The Trust owns the commercial mortgage loans and issues various tranches of certificates which are secured by the loans.
  – The Trust is administered by a trustee that is responsible for making payments to the certificate holders.
  – The Trust engages the servicer(s) to service the loans.
Key Players

• **Investors/Certificate Holders**
  – Investors purchase the certificates issued by the Trust.
  – Certificates are issued in various tranches, and the various tranches are repaid in a predetermined order.
  – Independent rating agencies rate each of the certificates based on likelihood of repayment.
Key Players

• **Master Servicer**
  – Head servicer for all performing loans
  – Ultimately responsible for approving or denying all material borrower requests
  – Responsible for collecting payments and property and borrower information
Key Players

• **Primary or Sub Servicer**
  – Often the originator of the loan
  – Borrower’s first point of contact -- handles day to day administration of the loan and requests for modifications.
  – Typically cannot unilaterally approve or deny material borrower requests, and passes on requests and recommendations to master and/or special servicer
Key Players

• **Special Servicer**
  – Head servicer for all non-performing or defaulted loans.
  – Consent of special servicer typically required for all material borrower requests on performing loans.
Post-Securitization:
“Hello, are you my mother/lender?”
What is a REMIC?

• **Real Estate Mortgage Investment Conduit**

  • The holder of the loans in a securitized mortgage loan pool will typically elect to be treated for tax purposes as a REMIC (Real Estate Mortgage Investment Conduit).
  • A trust which has elected to be treated as a REMIC, holds a pool of mortgages and issues securities (in the form of certificates) backed by the mortgages on real property.
  • The Tax Code and Regulations (the “REMIC rules”) provide that a REMIC Trust is not subject to taxation, provided the Trust complies with the REMIC rules.
Restrictions on REMICs

• The REMIC rules impact loans which have been securitized, and limit the changes that the Borrower and Lender can agree to once the loan has been securitized. A lender (servicer) will not permit a loan to be modified if such modification would jeopardize the REMIC status of the Trust.

• Except under certain limited circumstances, a REMIC is not permitted to modify a loan, if such modification would be deemed “significant” under the Internal Revenue Code and Treasury Regulations. Strict limitations are placed on a borrower’s ability to:
  • modify the loan
  • add or release collateral for the loan
  • prepay the loan
How are securitized loans different?

- Structuring Requirements (SPEs)
- Defeasance
- Modification of Existing Loans
- Non-Recourse Provisions
**SPEs**

- Each Lender will have specific guidelines for the organizational structure of a Borrower (known alternatively as the Single Purpose Entity, Special Purpose Entity, Bankruptcy Remote Entity, or Special Purpose Bankruptcy Remote Entity requirements)
  
  - Multi-Member vs. Single Member LLC (SMLLC)
  - If you are thinking SMLLC, think Delaware
  - “Recycled” SPE
  - SPE requirements in loan documents/organizational documents
  - Independent Directors/Manager
  
- SPE’s help to minimize risk factors relating to bankruptcy unrelated to loan and collateral
  
  - By limiting cash demands and potential liabilities unrelated to the collateral
  
  - By limiting likelihood that collateral will be consolidated into the bankruptcy of an affiliated entity
### Borrower Structure Single Purpose/Bankruptcy Remote Borrower /Loan Requirements

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<td>Single Purpose/Single Asset Borrower Entity; Structure and Loan Covenants</td>
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Defeasance: *I just want out!*

**Defeasance**

- What is defeasance? Borrower is required to purchase government securities for the Lender’s benefit in amounts which match the interest and principal payment due under the loan. The Lender accepts the treasuries as substitute collateral and releases its lien on the mortgaged property.

- Defeasance vs. Yield Maintenance
Defeasance Provisions in the Loan Documents:

Commonly Negotiated Defeasance Provisions:

- **Defease Only Through the First Open Date:** Borrower should have the option to defease the loan through the date on which the loan is first payable without penalty (often 30, 60 or 90 days prior to the stated maturity date), rather than providing defeasance payments through the maturity date.

- **Defeasance Collateral:** The Treasury Regulations require the Borrower to substitute “government securities” in connection with the defeasance of a loan. United States Treasuries are the most common, but most expensive, of the “government securities”. The loan documents should be modified to permit the Borrower to post defeasance collateral consisting of any government securities which have been approved by the rating agencies, rather than simply posting United States Treasuries.
Transfers of Ownership Interests

• Review transfer (due on sale provisions) – they may restrict more than you think…

• Typical restriction on transfers:

Borrower shall not sell, convey, mortgage, grant, bargain, encumber, pledge, assign, grant options with respect to, or otherwise transfer or dispose of (directly or indirectly, voluntarily or involuntarily, by operation of law or otherwise, and whether or not for consideration or of record) the Property or any part thereof or any legal or beneficial interest therein or permit a Sale or Pledge of an interest in any Restricted Party (collectively a “Transfer”), without the prior written consent of Lender, which consent may be withheld at Lender’s sole election.

• CMBS mortgages generally include transfer fees of 1% of the outstanding loan amount.
Transfers of Ownership Interests

• Understand the structure of the Borrower (all of the way up), and understand what transfers the client (and their principals) may need to make in the future.
  - corporate reorganizations / transfers to affiliates
  - transfers at the (upper tier) operating company level
  - transfers resulting from buy/sell provisions
  - estate planning/personnel changes

• Avoid the headache and expense -- review and negotiate the transfer provisions up front (in the loan commitment if possible)
Release of Collateral

• Unless specifically provided for in the loan documents, once a loan is securitized, the Borrower may not be able to obtain a release of any portion of the property which secures the loan.

• Unless specifically provided for in the loan documents, once the loan is securitized, the Borrower can’t even add a substantial amount of the collateral for the loan.
Releases: Unilateral Options

• If your client anticipates the need to release or otherwise alter the property after the loan closes, you should negotiate a unilateral option for the modification in the loan documents.

  – Under a unilateral option, the exercise of the option does not require the consent of:
    • the lender
    • a related party
    • a court arbiter

  – The exercise should not require payment of consideration unless the amount is minimal, specified or based on objective financial information.
Non – Recourse Carve Outs

• Although typically “non-recourse” or “limited recourse”, a securitized loan will traditionally involve a guaranty of certain exceptions to the non-recourse provisions.

• Lender will typically require an individual (a “warm body”) with an acceptable net worth, to execute the guaranty of the exceptions to non-recourse.

• The loan documents typically feature two tiers of acts that trigger liability (carve-outs).
  – Limited recourse carve outs - the lender’s recovery against the guarantor will be limited to lender’s actual losses
  – Full recourse carve outs (“Bad Boy” carve-outs) - the loan becomes fully recourse to the borrower if:
Full Recourse Carve Outs

Typical Full Recourse Carve Outs:

- Fraud or material misrepresentation
- Failure to maintain status as an SPE
- Breach of transfer provisions
- Bankruptcy
- Subordinate Financing
Limited Recourse Carve outs

- Misapplication of insurance or condemnation proceeds
- Waste
- Misapplication of security deposits
- Receipt of rent paid more than one month in advance
- Misapplication of proceeds after an Event of Default
- Damage to the Property as a result of the intentional misconduct or gross negligence of Borrower
- Failure to pay taxes, assessments, or liens
- Compliance with environmental laws and regulations
Conclusions

• Securitized Loans are unique. Once the loan has been closed, Lenders may be unwilling or unable to modify the existing loan – even for transactions that “make sense”.

• If it is important to the Borrower, PUT IT IN THE LOAN DOCUMENTS.
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