

DISRUPTION IN THE CAPITAL MARKETS

What Happened?

By Joseph Philip Forte



Today, capital market investors feel as though they are poised beneath a convulsing octopus awaiting the octopus's next shoe(s) to drop. That is one way to look at the "good news/bad news" of the current market—many new asset classes such as real estate finance are now fully integrated participants in the global capital market but also are subject to seemingly random exogenous events in the international arena. Unlike prior disruptions, two new significant factors now drive recent events in the markets—the continuing trend toward globalization and the enormous growth of mortgage securitization. Both have influenced the unfolding problems in the capital market in ways that most participants, despite their full knowledge of all the accumulating factors, failed to foresee or predict with any accuracy.

Although dispersion of risk through securitization and globalization may be a good thing, market players failed to appreciate that dispersion also spreads exponentially the potential losses from that risk throughout the global capital market. With diverse investors crossing over from their traditional markets and their usual asset classes and using increasingly available leverage to invest in new asset classes and in newly developed structured finance products, liquidity grew enormously; but like any fully integrated system, the actual risk of loss permeated and eventually overran the entire system. It is a two-way highway that is no longer limited to special classes of institutional or private investors but now includes hedge funds, opportunity funds, private equity investors, and sovereign wealth funds, among others.

The effect on capital markets of this unregulated investor class—a shadow banking system—operating beyond the purview of government supervision will be discussed later

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in this article. To appreciate the full extent of these interrelationships, however, it is instructive to compare the current investor reaction to market turbulence with earlier events that led to the development of private label (nongovernment-sponsored enterprises) residential securitization more than 20 years ago. Joseph Philip Forte, *From Main Street to Wall Street: Commercial Mortgage-backed Securities*, Prob. & Prop. 8 (Jan./Feb. 1996).

Prior Market Dislocations

The federal tax reform of 1986 and the 1987 stock market crash were significant capital market events, but they had no discernible immediate effect on the real estate finance activity of traditional portfolio lenders across the United States. Real estate finance still was basically a local business, albeit done by some national lenders and influenced on the residential side by the growing presence of Fannie Mae and Freddie Mac. Information on mortgage loan performance (other than life insurance industry data) was limited, and there was a lack of transparency in real estate finance markets generally.

After the 1987 crash, portfolio lenders continued to finance property for nearly two years into the worst national real estate depression since the 1930s. With its new broader investment authority as a result of deregulation in the early 1980s, the savings and loan industry blindly led the boom market into significant overbuilding (and bust). The creation of the Resolution Trust Corporation (RTC), with its singular task of "resolving" the savings and loan crisis, quickly led to the development of a broader securitization market for commercial properties built on the already developing nascent private label residential mortgage-backed securities (RMBS) market.

The real estate securitization market broadened the existing investor class beyond the traditional portfolio institutional investor, broadened the asset class beyond residential, educated the new players, tested new securitization structures,

and legitimized the commercial mortgage-backed securities (CMBS) market. Money center banks quickly entered as participants into what had been a Wall Street investment bank business, eventually followed by insurance companies and most other institutional investors. In the senior/subordinate structure adopted by the private label market to provide credit support in the absence of the RTC's call on the full faith and credit of the United States for its market issuance, an entirely new class of subordinate investor was created—the B-piece buyer—who held the most junior or "first loss" position developed to provide credit support for the senior bond holders. Most of the new B-piece investors were former RTC contractors who had the capacity and, more importantly, the desire to own the properties securing defaulting loans. From a jerry-built start based on the existing residential securitization model, commercial securitization has grown into a dominant market participant—with an estimated 27% of all commercial mortgages outstanding (nearly \$900 billion) being securitized. Commercial Mortgage Sec. Ass'n, *Compendium of Statistics 25* (2008), available at www.cmbs.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf. The consensus among those in the commercial mortgage securities industry is that approximately 55% of the new originations were securitized.

The August 1998 market disruption for the so-called "Asian contagion"—beginning with the Thai currency devaluation through the Russian bond default—was a totally new experience. The CMBS market was in its formative stages but was growing exponentially. Even then, the difference from the 1987–89 disruption was the almost instantaneous speed at which global events in the capital markets affected the local real estate finance business. A mortgage loan that closed in the morning could not be priced or sold later in the day. Some issuers of CMBS, having

retained in their portfolios the B-pieces of their own CMBS deals and having accumulated billions of dollars of commercial mortgages to issue new single-sponsor, multi-billion dollar securitized pools, suffered significant losses to their holdings because of the adverse movement in the market for such assets. As a result they were severely and sometimes mortally punished by the market. Several major issuers, a major B-piece buyer, and a number of commercial and residential originators who accumulated loans and financed their positions with warehouse and other financing strategies were subject to margin calls and liquidation of their positions by their warehouse and/or accumulation lenders, resulting in several players exiting the market involuntarily. It did not take six weeks or six months for real estate lenders to react to capital market events; they reacted quickly and daily. The lesson from that market disruption was the risk of duration—how long could an originator or issuer risk holding an asset before it was removed from its balance sheet? The long-term effect of that disruption has been to significantly increase the velocity of loan transactions and concomitantly reduce the accumulation period of assets for the securitization in an attempt to mitigate the risk of sudden adverse market movements by holding fewer assets for a shorter period of time.

Another outgrowth of the 1998 dislocation was deal partnering—several issuers/originators joining together in branded programs to accelerate their ability to securitize their production in a single securitization trust while retaining the ability to issue larger deals in shorter time periods with the concomitant economy of scale benefits to the sponsors. Many of these “joint” ventures alternated the use of each participant’s MBS shelf registration and often further co-branded the joint issuance with some distinguishing feature, such as perceived high-quality underwriting (for example, insurance company quality—IQ brand or best or top quality TOP brand underwriter/originator programs).

By early 1999, the value of the mortgage positions that had been subject to substantial margin calls in August 1998 or actually seized and liquidated for failure to cover margin calls were “in the money” (within four months). The market had recovered almost as quickly as it had seized up that summer. The capital markets for real estate finance were again moving forward, with only a further slight disruption from the “Tech Bust” in 2000–01.

The effect of the terrorist attacks on September 11, 2001, however, was a serious shock to the real estate structured finance business. Aside from the human tragedy, the issuance and distribution of loans through securitization was changed forever. Suddenly, the risk of the complete loss of a single asset—a building or development such as the World Trade Center complex—and the lack of terrorism insurance for so-called “target” buildings required a significant shift in the way certain assets were to be deposited into CMBS trusts. There would no longer be single “trophy” asset securitizations. There was no way to effectively mitigate or “tranche” the risk of a total loss if there was only one asset. But it was also too difficult to place a large single asset in a conduit pool of small assets or in a “fusion” pool that mixed many small conduit assets with a few larger assets—the elephant still stood out among the mice.

The immediate solution was componentization—a variation on the earlier development of mezzanine debt—as an antidote for the credit rating agencies’ perceived risk of the bankruptcy of a second mortgagee negatively affecting the timely payment of interest and therefore ratings. Componentization is slicing and dicing a single large mortgage loan into several disparate senior/junior component parts—A-, B-, C-notes, and so on. Those notes could be further divided. The A-notes could be split into coordinate pari passu notes that could be deposited into several different CMBS securitizations as first mortgage loans, and the B-notes (and further subordinate notes)—whether

structured as co-lenders’ individual notes or pari passu or senior/subordinate participations in a single B-note—could be sold to capital market investors outside of the CMBS securitization in a growing subordinate debt market.

Current Market Conditions

With the componentization adjustment to the structured finance capital stack and the continuing historically low interest rate environment, the real estate finance market continued its enormous growth trajectory. The availability of capital continued to grow, spurred on by the appetite of capital market investors for more high-yield product. Yet most investors in these new capital market products were not cash buyers but looked to finance their investments as part of their strategy of maximizing their yields. Although the typical term warehouse, repo, and reverse repo lines were available to finance acquisitions, these lines of credit were floating rate loans and subject to being marked to market and margin calls by the lenders.

There was, however, a new technology—the collateralized debt obligation (CDO), which had been developed originally for the asset-backed securitization market. See John C. Kelly, *An Introduction to Commercial Real Estate CDOs (Parts 1 & 2)*, Prob. & Prop. 38 (Nov./Dec. 2007) & 55 (Jan./Feb. 2008). Wall Street adapted CDOs for use in the commercial real estate finance segment of the market. When a lender sells an asset, it does so to remove the asset from its balance sheet to free up capital and allow the institution to make a new loan as well as collect a new fee. Real estate lending went from being a portfolio business to a fee business—from a storage business to a moving business. Yet, by financing its purchaser in the sale of an asset, the loan seller is removing the asset from its balance sheet as owner but clearly reacquiring the risk of the newly pledged asset as lender. Therefore, the prospect of being able to remove assets from the seller’s portfolio without retaining the

risk of the assets on its balance sheet was a very appealing structure for asset sellers; the fixed interest rate and lack of mark to market requirements and margin call risk were big selling points for asset buyers looking for financing.

The availability of CDO financing led to a further explosion of loan products, which, because of Real Estate Mortgage Investment Conduit (REMIC) limitations, could not otherwise be disposed of by depositing them into an MBS structure—B-notes, mezzanine debt, B-pieces, and so on. Code § 860G(a)(3). The mortgage loan origination community was more than willing to accommodate this growing capital market investor appetite for subordinate debt products by increasing loan production as the lenders were able to serially clear inventory that would otherwise have been retained. Lending volume grew significantly, supported by growth of the commercial real estate CDOs, allowing the issuance of CMBS to reach record levels. But then what happened?

Unfortunately, the residential mortgage market had made even greater use of CDO technology earlier. For several years, there had been substantial issuance of residential MBS comprised entirely of so-called subprime loans to borrowers whose credit (and lenders whose underwriting) was substandard. The below A-rated tranches of these subprime securitizations, which would be more prone to default than prime residential loans, were perfect candidates (in the issuer or investors' estimate) for inclusion with other unrelated, often non-real-estate, assets into CDOs. Driven by this accelerating, readily available financing to subprime MBS investors, the subprime market exploded onto the scene, financing otherwise uncreditworthy borrowers in the acquisition of the American dream, a home of their own.

In April 2005, the then Federal Reserve chair remarked that CDO technology had changed lending: "Where once more-marginal applicants would simply have been denied credit,

lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in subprime mortgage lending . . ." Remarks by Chairman Alan Greenspan, *Consumer Finance*, at the Federal Reserve System's Fourth Annual Community Affairs Research Conference, Washington, D.C., Apr. 8, 2005, available at www.federalreserve.gov/BoardDocs/speeches/2005/20050408/default.htm. Ultimately, subprime loans may be in upwards of 50% of the outstanding noncommercial real estate CDO collateral pools. The subprime business began to unravel in early 2007, however, as subprime loan defaults began to increase and investors began to distrust the AAA rating of CDO structures now burdened by lower tranches of subprime RMBS.

It would be rational to assume that the subprime loan "meltdown" (as the media coined it) would be a self-contained event—as risky overleveraged residential loans to uncreditworthy individuals. But this is where securitization and globalization enter our analysis of the current problems in the capital markets.

"Connectivity" is the making of common investments in an esoteric segment of the global capital market by an interconnected web of investors from all asset classes. The common investor's investment risk migrates and eventually infiltrates the entire system. As the investments became more diverse, so did the pervasion of any problem into seemingly unrelated or unconnected portfolios. It was akin to an uncontrollable (and invisible) "contagion." Clearly, investors had misperceived and mispriced an otherwise obviously risky investment because the credit rating agencies had rated the CDO transactions using the identical ratings granted to MBS transactions in the long-standing "quality" residential and commercial MBS markets. With most American floating rate debt sold to European and other foreign investors or foreign subsidiaries of U.S. companies, the contagion affected international as

well as domestic investors. It is difficult to assess whether foreign investors actually understood the collateral for the CDOs they purchased or blindly relied on those published credit ratings. In any event, the subprime contagion could not be contained. There are no firewalls between asset classes in the capital market. The connectivity of the global capital market and its common investors went into overdrive. Suddenly, real estate was faced with a credit crisis created by an exogenous market. Overseas investors in floating debt rate financing went on strike (according to the *Financial Times*), refusing to purchase any real estate structured finance instruments—viewing all bonds secured by real estate, either residential or commercial, as toxic in spite of continuing strong real estate fundamentals in the commercial real estate markets generally. Henny Sender, *PHH Deal Failure Shows Wider Market Gloom*, *Fin. Times*, Jan. 1, 2008, available at www.ft.com/cms/s/0/b96305bc-b8c1-11dc-893b-0000779fd2ac.html?nclick_check=1. As a result of the turmoil, securitized lenders were unexpectedly caught with a "held for sale" inventory on their books (as opposed to their "hold for investment" books) of more than \$100 billion, which their usual investors would not buy. Suddenly, all MBS—commercial as well as prime residential—were viewed by investors with the same fear and suspicion as CDOs. Most investors did not appreciate or understand the difference in the structures or in the underlying collateral.

Ultimately, all structured finance was viewed by investors as a single bad asset class to be avoided at all costs. This was the definitive step in the perfect storm that was to develop from the confluence of a series of seemingly unrelated and disparate events. Soon financial institutions and institutional investors were taking unheard-of write-offs for an esoteric asset class in the context of a spreading market contagion. It soon became apparent that much of the investment in CDOs was by so-called structured investment vehicles (SIVs)—bank-

sponsored, off-shore entities using short-term commercial paper borrowings to make investments in long-term CDOs, which were often populated with subprime loans. Borrowing short and lending long was the historic strategy of the American thrift industry, which had been criticized by Wall Street in the 1980s as a basically flawed business model. That did not prevent the creation of numerous SIVs to support the burgeoning CDO market. This \$400 billion bank-sponsored misadventure ran into trouble when the commercial paper markets dried up in conjunction with the subprime meltdown. To avoid wholesale failures of their sponsored SIVs, the banks simply began to fund the SIVs, importing their problems onto the banks' balance sheets—precisely what SIVs had been created to avoid.

As this trend continued, market turbulence disrupted pending securitizations and purged buyers from the market completely; it became almost impossible (or at least extremely risky) to attempt to value an asset or to price a risk. Fearing all real estate collateral, investors demanded higher yields or withdrew entirely from the market. As uncertainty prevailed, pricing pre-existing commitments became increasingly problematic for those in the leveraged finance business.

Corporate mergers and acquisitions, unlike traditional real estate finance today, require hard commitments before the parties move forward with their transactions. The purchaser's acquisition financing must be in place before the merger process proceeds with the seller. Many commitments had CMBS financing components. Over the last several months, the \$330 billion in outstanding leveraged finance commitments held by banks have begun to fund but have been delayed by discussions of "material adverse change" clauses in merger documents and/or financing commitments and the retrading of pricing for purchases and/or financing. As these loans close and cannot be securitized or syndicated, the lenders will take their losses—another

negative factor for the markets as these loans eat away at required bank capital levels.

Looking for a culprit, investors and the media began to focus on national credit rating agencies, accusing them of becoming "toll takers" instead of "gatekeepers" for the marketplace and suddenly seeing an inherent conflict of interest in issuers paying for the rating of their securitization pools. Historically, investors, not issuers, had paid for the rating process, but then the ratings were issued in private to the paying investor and not publicly. That would not work in a public market that relies on transparency and publicly announced ratings. Others had taken the view that the rating agencies improperly applied the criteria for MBS structures to the very different CDO structures and inferior collateral, especially in the case of subprime loans. Beginning in April 2007, however, the rating agencies announced adjustment of subordination levels on commercial MBS. This new position of the agencies only confirmed the doubts of investors and exacerbated the problem. Jim Duca & Tad Philipp, *US CMBS: Conduit Loan Underwriting Continues to Slide—Credit Enhancement Increase Likely*, Moody's Structured Fin. Spec. Rep., Apr. 10, 2007.

Wherever the truth lies, some investors often did not look beyond the announced credit rating—not even to review the rating agencies' published short pre-sale report on each MBS or CDO deal that provides the rationale for their ratings based on analysis of the loans and the pool regarding the collateral, property type, borrowers, geographic diversity, and so on. Many investors were relying almost entirely on letter ratings, deal sponsorships, and ever more attractive pricing, and almost never read the offering disclosure documents. If they did read the disclosures, they did not fully understand and appreciate the nature of the risk.

Add to this turbulence the lingering concerns with Enron and its progeny. Under generally accepted accounting principles (GAAP), assets

held for investment do not need to be regularly marked to market, but the issuers' and originators' assets were held for sale and required to be marked to market. The fear of improperly marking an asset "to model" instead of "to market," even when there is effectively no market, was chilling. Hence, many investors have marked their subprime-related investments to zero, although clearly there will be substantially more value to those CDO assets when the individual loans are all finally resolved.

In the CMBS market, without any "cash" marks available from other traders (two are necessary to mark an asset to market), the participants turned to the newly created Commercial Mortgage Backed Securities Index (CMBX)—a derivative now based on five extant six-month pools of CMBS issuance. Although some dealers and investors see the CMBX as a hedge instrument, it is often traded by non-real-estate traders and speculators who may be causing significant distortions of values and pricing for the cash market. It is now widely believed that this highly technical and thinly traded CMBX market actually makes it harder to determine the value of, or to establish the price for, an asset acceptable to market participants. The CMBX index may be a major obstacle to the recovery of the markets today. Edwin Anderson, *Fool's Gold: Evaluating Loss Estimates for the CMBS Marketplace*, CMBS World, Summer 2008, at 22, available at www.cmbs.org/WorkArea/showcontent.aspx?id=14776.

As hedge funds and other nonregulated investors began to replace insurance companies as the principal purchasers of senior CMBS bonds (by some estimates 40% in 2006), the benefit of transparency provided by public ownership disappeared and concern arose over who actually owned the CMBS certificates. The memory of Long Term Capital dumping an enormous hoard of highly leveraged CMBS into the market still lingers with many investors. When will they take their losses? How much did they finance and with whom? What are they holding? What if they all dump at once into an already fragile market? Investors hesitate to purchase for fear that the next shoe will drop and they will have paid

too much for an asset. They see a risk in every move they take and inaction seems preferable in a market that needs trades to move forward. Whom can you trust? They already believed that they had “misplaced” trust in credit ratings. Credit is about trust—by its etymology from the Latin, credit means “he believes.” Hence, when there is no trust, there is no credit. How do you restart? You create trust among market participants—originators, issuers, rating agencies, senior investors, junior investors. Without trust there is a credit crunch—a loss of liquidity.

Is Securitization the Problem?

But what about securitization? Is it actually a flawed model and destined to be consigned to oblivion? Before any portfolio lenders or other traditional investors rejoice at the prospect of reduced competition from the capital market players, consider some basic points. Since 1986, the United States has lost a significant number of the traditional lenders who financed 100% of the real estate market in that year. Substantially fewer traditional lenders were still in business after

[a] series of events, including the savings and loan crisis and the stiffening commercial bank regulatory environment in the late 1980s, led to a national real estate depression in 1990 that effectively strangled the flow of Main Street capital to commercial real estate. The credit crunch that followed severely impacted real estate and real estate investors, affecting lenders as well as owners.

Joseph Philip Forte, *A Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street*, 31 Real Prop. Prob. & Tr. J. 489 (1996). Today, many commentators believe that the number of traditional lenders has continued to decline despite the influx of foreign institutions. Less capital available for finance results in a depression in real estate values. Real estate values depend on the availability of credit. Insurance companies and regional banks combined (as well as those remaining money center banks with portfolio lending capacity) could not nearly

replace the capital that would be lost if securitization were to end. Moreover, regional and local banks, which are providing substantially more capital to commercial real estate markets than insurance companies, are significantly more overexposed to real estate as an asset class—being multiples of their capital. This situation is the cause of serious concern for federal and state banking regulators. Saskia Scholtes, *Small US Banks Feel the Pinch*, Fin. Times, June 29, 2008, at 16. As the Capital Consortium reported in the midst of the last credit crunch: “This dearth of capital resulted in a drop in property values, dampened investment returns, increased delinquencies and foreclosures, as well as industry layoffs. In turn, this resulted in an erosion in state and local tax bases, which adversely impacted community services.” The Capital Consortium, *Capital Markets Initiatives*, June 25, 1996, at 1.

The problem is not with securitization, but with securitizers’ and investors’ almost incredible mispricing of risk. It is as though investors thought that somehow the securitization process had taken all the risk out of real estate financing. Definitely, a very wrong conclusion—ask any B-piece buyer who does due diligence on collateral. Too much capital, lower interest rates, increased leverage, increasing values, lower cap rates, and so on, have taken down booming real estate markets before. Securitized lending was no exception. The difference was that the risk was not being assessed for the term of the loan, but almost at the point of origination. Make it and sell it. *Chain of Fools: Hard Evidence that Securitisation Encouraged Lax Mortgage Lending in America*, The Economist, Feb. 9, 2008, available at www.economist.com/finance/displaystory.cfm?story_id=10641119. The pressure to compete with other lenders—lower rates, more proceeds—simply overwhelmed the process. Volume was emphasized over pricing of risk. Issuers viewed themselves as exporting the risk—it was someone else’s risk after it was securitized. But as has been seen, it does not always work

out quite like that. Assets have a way of migrating back to an issuer’s balance sheet through a term financing of asset sales or an investment in an asset by a subsidiary such as a SIV or other alternative investment unit. Thus, the seeds of the current turmoil have been planted over the last several years.

Credit rating agencies began the long march of reducing subordination levels on CMBS transactions despite drawbacks such as more questionable loans, little or no amortization, no reserves, no recourse, lower debt service coverage ratios (DSCRs), and higher loan-to-value (LTV) ratios. The enormous growth of subordinate debt (often financed), interrelated pools of pari passu A-notes, exceedingly complex capital stacks with intercreditor issues, and less (if any nonfinanced) hard equity also exacerbated the situation.

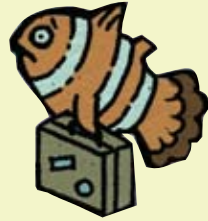
Commercial mortgage loan delinquencies remain low by historic standards at less than 0.5%. *Compendium of Statistics*, supra, at 8. Even at multiples of three or four times, that number would still be very low by such standards and not overly disruptive to the market. But much of the risk is in floating rate debt and loans with little or no amortization, both of which may have significant refinancing risk. In 2007, more than 80% of commercial loans had an interest-only component while more than 45% were interest-only through maturity. With any perceived weakness in commercial real estate fundamentals, these loans on maturity may not be able to be refinanced as underwriting standards tighten for new loans.

The Future

Before the capital markets for real estate finance can return to equilibrium, investors must once again perceive those markets to be predictable and reliable. Investor trust must be renewed in the asset class, in the underlying collateral, in the rating agencies, and in the other participants in the marketplace. This will require that several things happen before participants can “believe” in the market and credit can flow again. For a discussion

PERFECTION OF SECURITY INTERESTS IN THE OWNERSHIP INTERESTS OF BORROWERS UNDER A MEZZANINE LOAN

ARTICLE 9 VS. ARTICLE 8



By Richard R. Goldberg

The only safe way to perfect a security interest in the ownership interest of the mezzanine borrower is to require that the borrower opt into Article 8 of the UCC (so that such ownership interest is a certificated interest), agree not to opt out of Article 8, and deliver the certificated interest to the mezzanine lender along with a blank power. The agreement not to opt out should be backed up with a recourse event in a guaranty by a sponsor capable of paying under the guaranty.

Mezzanine lenders, however, often do not take this approach. As with promissory notes, major financial institutions have a propensity to lose the certificates because of the volume of pledged loans. Therefore, they prefer to secure the ownership interest with an Article 9 filing instead. Following this approach, however, leaves the mezzanine lender in a precarious position because possession trumps filing and the possessor does not take subject to a previous filing. U.C.C.

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§ 9-328. Likewise, a control agreement regarding certificated interests also is trumped by a pledge with possession.

The mezzanine lender should avoid this situation if at all possible because of substantial risks to its security. If the borrower, whether inadvertently or by design, later grants a security interest of control to a third party (either by possession or by the execution of a control agreement), the lender with priority by control does not take subject to the Article 9 interest. Although one would hope that a subsequent lender would perform the obvious UCC filing searches for prior interests, if a subsequent lender nevertheless takes possession, this leaves the holder of the interest secured by an Article 9 filing with little recourse. The defeat of the grant of the security interest would result in a breach of a covenant in the loan agreement; perhaps there will be a cause of action for fraud; and, if the loan agreement is properly drafted, there will be recourse to a guarantor of substance. But, even if the mezzanine lender has a cause of action in contract and fraud, it cannot get at the membership interest. In the author's experience, a

borrower willing to commit these acts usually does not have the financial resources to make the lender whole.

This situation brings to mind a theory for counteracting the potential drawbacks of Article 9 perfection. A possible solution may lie within the provisions of the Delaware Limited Liability Company Act. Del. Code Ann. tit. 6, § 18-101 et seq. Mezzanine lenders should be more emphatic in insisting that Delaware be the state of choice for entity formation purposes. Although many mezzanine borrowers are formed in other states, in these uncertain times lenders will take comfort in the way Delaware has interpreted limited liability company law as well as in the uniqueness of certain provisions of the Act.

Lenders should require that the Delaware mezzanine borrower's limited liability company agreement provide that the entity will not opt into Article 8 without the permission of the mezzanine lender. The operating agreement should also provide that the agreement will not be amended in any respect without the consent of the mezzanine lender. The Act provides as follows:

of an earlier securitization market, see Louis Perlstein, *What the 1920s Tell Us About Mortgage-Backed Securities Today*, Prob. & Prop. 19 (Jan./Feb. 1987).

To assure stability, investors currently holding assets, whether or not marked to market, must realize their losses on their balance sheets so that investors do not hesitate to invest because of fear of further bad news. Once the losses are taken, the fear of unknown holders of undetermined assets with unknowable connections to other participants will dissipate from the market. The collateral for CMBS transactions

can only be rehabilitated once the pre-credit crunch excess is sold off and not buried in new post-credit crunch MBS. New stricter underwriting standards—higher DSCR, lower LTV, no or fewer interest-only, amortization, reserves, recourse carveout guarantees—will foster confidence in the commercial loan assets originated for sale. Rating agencies will need to regain the respect and trust of market participants before anyone will be truly comfortable with relying on their CMBS ratings. All origination and securitizer participants in the market, however, have many significant

obstacles to overcome before they can reenter the market and be viewed as trustworthy by investors. The leveraged finance lenders will need to close and fund under their commitments and realize their losses. The SIV-sponsor banks will likewise be expected to publicly disclose and realize their losses on their balance sheets. Moreover, commercial banks and investment banks will have to continue the process of rebuilding their required capital to remain effective market participants.

Yet all this affirmative action will be for naught if the subprime loan debacle is not effectively and quickly dealt with.

If a limited liability company agreement provides for the manner in which it may be amended, including by requiring the approval of a person who is not a party to the limited liability company agreement or the satisfaction of conditions, it may be amended only in that manner or as otherwise permitted by law (provided that the approval of any person may be waived by such person and that any such conditions may be waived by all persons for whose benefit such conditions were intended).

Id. § 18-302(e). Thus, the operating agreement cannot be amended without the consent of the mezzanine lender and any amendment may indeed be an ultra vires act by the entity. The mezzanine loan agreement should also provide for a similar “no opt in” covenant and the guaranty should provide for a recourse event if the covenant is breached.

To complete the picture, the mezzanine lender should insist on one additional step, which does not have the force of law but creates a notice situation to any future prospective lender. The certificate of formation for a Delaware limited liability company permits the entity to place comments on the face of the form. Id. § 18-201(a)(3). A comment should note that the operating agreement does not permit the limited liability company to opt into Article 8.

Although this comment has no effect of law, it compels notice of a possible competing Article 9 filing to any party that has an interest in requiring the entity to opt into Article 8. There is no assurance that the suggestion above will work to prevent a limited liability company from opting into Article 8. If the mezzanine lender prefers to perfect under Article 9, however, it is worthwhile to consider insisting that the borrower follow these steps when preparing the mezzanine borrower’s formation documents.

It should be noted the technique suggested above applies to Delaware limited liability companies and Delaware limited partnerships. In other states, the provisions of the UCC trump the organic formation statutes for limited partnership and limited liability companies. Also in some states, the use of a limited liability company causes significant state tax problems that necessitate the use of a limited partnership. The suggested technique can still be used in such a situation, however, because the general partner of the limited partnership can always be required to be a limited liability company and the prohibition can be applied in the general partner’s operating agreement.

In any event, there is no substitute for the use of Article 8 to perfect a security interest in ownership interests. The use of the Article 9 solution is a Band-Aid at best and not a substitute for the methodology provided by Article 8. ■

Government intervention in the nature of a moratorium or other market controls will serve only to destroy the interest of foreign investors in U.S. “free” markets. Clearly, the economic chill from “pushing legislation to freeze foreclosures on homes with subprime mortgages in the name of ‘protecting the American dream’ . . . would likely be felt around the world by pension plans, banks and municipalities that have invested in mortgage-backed securities.” Amity Shlaes, *Judging the Judges*, Wall St. J., May 1, 2008, at A15. The effect of the foreclosure moratorium and other well-meaning government controls on the real estate finance market

during the Depression, in the author’s view, resulted in the exclusion of real estate finance from access to capital markets and its broad range of investors for almost 50 years. Government intervention together with the dearth of traditional portfolio investment would be a catastrophic result for real estate investment in this country.

Whatever route the capital markets take to eventual stabilization, the inevitable destination facing returning real estate investors is the world of “de-leveraging.” Unlike the early 1990s, there has been no significant

overbuilding in the last few years. As a result, there is no oversupply of existing properties or delayed absorption of newly built properties into local real estate markets. What has been overbuilt are not physical structures but the capital stock of most real estate transactions with serious overleveraging. The major default risk in commercial real estate finance markets today is not so much borrower payment default but maturity default. After years of being discussed, the much-feared balloon refinancing risk has finally arrived. The recent exponential growth in leverage at all levels of the property financing stack—pari passu and subordinate mortgage and mezzanine debt—must be “de-levered” in the new market as investors adjust their appetite for risk and pricing. The loss of leverage will be neither absorbed by traditional portfolio lenders nor by securitized lenders facing new underwriting criteria and more conservative investors. New players are needed to refinance the shortfall between senior and subordinate debt. The author has learned from people knowledgeable in the industry that private equity funds would participate at this level and might also step in to provide the bridge financing for that shortfall. Migration of financing will be from pari passu senior notes to subordinate B-notes to mezzanine loans but all at new (more risk-averse) terms and pricing.

Opportunistic private equity funds have been organized, funded, and are waiting in the wings for distressed assets to be offered for sale by investors. Unfortunately, the pre-credit crunch seller and post-credit crunch buyer will be at a standoff until each recognizes stabilization in the markets. When participants begin to trust one another again and begin to reach agreement on the value and price of assets, the market will once more move forward. It may be a plain vanilla asset market with simpler structures, but it will be a strong base on which to continue to build an efficient capital market for real estate investment globally. ■