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Analyzing Securitized Mortgages On Commercial Property

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The recent collapse in the credit market and decline in value of commercialproperty has led to a staggering number of defaults of commercialmortgages over the past two years. In prior periods of recession, borrowers' attorneys had some degree of success in "working-out" or restructuring commercial real estate loans with banks or other traditional lenders. This time around, however, such work-out efforts have been complicated, and in many instances entirely frustrated, by the fact that a large portion of the mortgagesoncommercial real estate that are now distressed have been "pooled" and used to secure the issuance of commercialmortgage backed securities (CMBS).

Notwithstanding the challenges now facing borrowers' attorneys, there are indications that attorneys who understand how CMBS transactions work and the players involved in such transactions are beginning to have some success with foreclosure defenses, as well as affirmative lender liability claims, that either have been, or likely would have been, rejected by courts in the past. Indeed, judges appear to acknowledge that CMBS transactions are the very type of exotic investment instrument that contributed to the current economic condition, and seem willing to entertain new and creative legal theories for dealing with distressed real estate that has been securitized.

CMBS Structure

To effectively represent a borrower in negotiating with, or litigating against, a CMBS lender, it is important that practitioners know the parties involved, and understand the structure of a CMBS transaction.

Traditionally, commercial real estate loans were originated by banks, or other similar lenders, who then serviced the loans to maturity, or sold the mortgages to other traditional type lenders who serviced them. Whatever entity that serviced the loan would do so whether the loan was current or in default.

In a CMBS transaction, the entity that originates the loan, sells the mortgage (usually immediately) to a special purpose bankruptcy remote trust. These trusts purchase multiple commercialmortgages to form a diverse "pool" of loans, which provide the collateral for the issuance of securities, typically bonds.

The "trustee" of a CMBS trust holds legal title to the mortgages, although having virtually no involvement in the day-to-day servicing of the loans in the pool. It usually does, however, have some supervisory authority over the loan servicers.

The CMBS "master servicer" is usually charged with servicing loans in the pool while they are performing, or "untroubled" loans.

A "special servicer" is also usually employed by the trustee to handle workouts and foreclosures for distressed loans in the pool. Usually when payment of a loan becomes delinquent, or default appears imminent, servicing of the loan is shifted from the master servicer to the special servicer, which is charged with either modifying the loan to return it to performing status, or foreclose on the mortgage.

Typically, a pooling and servicing agreement governs the relationship among these various parties involved in administering and servicing the loans in a CMBS pool.

Problems With Negotiating

While the role of each of the CMBS players may seem simple and well-defined, the division of responsibilities and authority among these various entities creates a roadblock for borrowers who desire to discuss a loan restructure.

It is a common scenario for a borrower, who finds that the income and value of a commercialproperty no longer support the debt on the property, to feel "stonewalled" when reaching out to try to negotiate the debt with a CMBS and avoid foreclosure litigation. In the traditional work-out situation, the challenge for a borrower's attorney was, once you got in contact with a person at the lender bank with authority to restructure the loan, how do you persuade that person as to why the bank should restructure the loan and avoid foreclosure? With a CMBS transaction, there is the initial, often insurmountable hurdle, of "who should I be speaking with to restructure my loan, and why won't they speak with me?"

When borrowers contact their master servicer, usually the only servicer that the borrower has had any contact with or even is aware of before there is a payment default, they are usually told that the master servicer has no authority to restructure a loan; only the special servicer has such authority. When asked to be put in touch with the special servicer, it is not uncommon for master servicers to refuse to give borrowers the special servicers' contact information. Even if the borrower is fortunate enough to get in contact with the CMBS special servicer, the typical response is that the special servicer will not, or cannot, discuss a loan restructure with a borrower until the loan is in default.

Even after a default, special servicers will generally refuse to discuss loan restructure with a borrower unless the borrower agrees to sign a "pre-negotiation letter," acknowledging the indebtedness

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and waiving all defenses that the borrower might have in a foreclosure action. As discussed below, a borrower could be giving up important substantive rights if such a "pre-negotiation letter" is signed without substantive revisions.

Thus, the CMBS structure makes it virtually impossible for a borrower to be proactive in discussing a distressed property with its "lender." Until the loan is in default, and presumably a foreclosure action in the works, the CMBS players as a group will not even discuss work-out alternatives with the borrower.

So what can a borrower do in dealing with a CMBS lender?

Litigating With CMBS Lenders

While representing borrowers in negotiating, and litigating, with CMBS lenders can sometimes feel like a daunting task, there appears to be some sunlight on the horizon. In recent decisions, judges have shown that they are not blind to the current economic crisis, and courts have generally seemed more willing to accept new, or previously rejected, defenses and claims by debtors against lenders, CMBS lenders and otherwise. Those defenses, of course, might not be available if a "pre-negotiation letter" is signed by the borrower.

For example, in *Hoosier Energy Rural Electric Cooperative v. John Hancock Life Insurance Co.*, a federal court, in granting a preliminary injunction against a lender from declaring a default against the borrower or demanding payment, held that a borrower had established a reasonable likelihood of success on the merits of a defense of "temporary commercial impracticability."[1] In so holding, the court noted that "the credit crisis facing the world's economies in recent months is unprecedented and was not foretold by the world's preeminent economic experts."

On appeal, the U.S. Court of Appeals for the Seventh Circuit acknowledged that "New York takes a very dim view of 'impossibility' defenses and has never suggested that, when an impossibility defense is unavailable, a 'temporary commercial impracticability' defense might serve instead."

Yet, the appellate court affirmed the District Court's grant of a preliminary injunction, apparently finding temporary impossibility (as opposed to impracticability) of performance might be demonstrated. Clearly, and expressly, in granting the preliminary injunction, the *Hoosier Energy* court considered the current economic challenges facing borrowers in reaching a decision that, historically, would likely not have been reached by a court applying New York law.

Similarly encouraging to borrowers' counsel in New York is the recent Fourth Department decision in *Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp*. There, the Appellate Division affirmed an order of the trial court granting a preliminary injunction which required a lender to fund "pending draw requests." In analyzing the irreparable harm that the borrower would suffer in the absence of the requested preliminary injunction, the appellate court took "judicial notice of the economic conditions that prevailed when Citigroup ceased making the loan advances," and "conclude[d] that, for purposes of a motion for a preliminary injunction, Destiny Holdings has established a probability that funds to replace the loan proceeds were not available elsewhere."[2] In reaching this surprising result, the Fourth Department not only acknowledged the changed economic conditions currently facing borrowers, but went so far as to formally take judicial notice thereof.

Perhaps most surprising was the recent decision from Supreme Court, Suffolk County in *Indymac Bank F.S.B. v. Yano-Horoski*. There, as a sanction for a lender's wrongful conduct in entirely rebuffing efforts by a borrower to restructure or "work-out" residential mortgage, the court not only dismissed the bank's foreclosure action, but went so far as to cancel the indebtedness and discharge the mortgage entirely. The *Indymac* court stressed the fact that foreclosure of a mortgage is a suit in equity and that the lender's conduct was "wholly unsupportable at law or in equity, greatly egregious and so completely devoid of good faith that equity cannot be permitted to intervene on its behalf."[3]

While *Indymac* involved a residential mortgage, its reasoning seems particularly applicable to CMBS situations, where borrowers have often been entirely rebuffed in efforts to discuss loan restructure or "work-out" with lenders. It is cautioned, however, that the *Indymac* decision is under appeal.

These cases are just a few examples of recent instances in which courts have shown a willingness to accept new or unorthodox defenses and claims to address the quagmire facing borrowers in dealing with CMBS lenders.

In addition to judicial developments, the U.S. Treasury Department recently adopted rules encouraging Real Estate Mortgage Investment Conduits, such as CMBS's, to revise commercial loans, by removing the threat that such revisions could trigger tax penalties. The new Treasury rules explicitly acknowledge that "[t]he current situation in the credit markets is affecting the availability of financing and refinancing for commercial real estate."[4] Thus, courts are apparently not alone in their recognition of the problems that borrowers are facing in negotiating with CMBS lenders.

Conclusion

While the emergence of the CMBS market has created certain unique, and very often frustrating, challenges for attorneys representing borrowers who wish to restructure their loans, courts have recently shown a willingness and ability to recognize those challenges, and to adapt and apply the law in a pragmatic way against the backdrop of the current economic downturn.

With the aid of skilled legal representation of borrowers, hopefully the new defenses and affirmative claims recognized by courts will not only alter the course of commercialmortgage litigation, but will also encourage lenders, especially non-traditional lenders such as CMBS lenders, to change the way they view pre-default discussions with the owners of the increasing number of commercialproperties that are now experiencing financial distress

1. 588 F.Supp.2d 919 (S.D.Ind. 2008), aff'd, 582 F.3d 721 (7th Cir. 2009).
2. N.Y.S.2d, 2009 WL 3790441 (N.Y.A.D. 4th Dept. Nov. 13, 2009).
3. N.Y.S.2d, 2009 NY Slip Op. 52333(U) (Sup. Ct. Suffolk Co. Nov. 19, 2009).
4. Rev. Proc. 2009-45, 2009-40 I.R.B. 471, 2009 WL 2934308 (IRS RPR).