CORONAVIRUS RESOURCE CENTER

CMBS Loan Workouts During COVID-19: A Borrower's Perspective

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Introduction

The COVID-19 pandemic has disrupted every facet of our economy, with commercial real estate being severely impacted. Countless property owners have been forced to shutter their doors, including hotels, shopping centers and office buildings. Tenants at shopping centers and some office buildings are struggling to pay rent or have stopped paying rent altogether and are petitioning their landlords for rent relief. Similarly, many hotels are closed or are running at extremely low occupancy, putting their properties into a positon where they are producing negative cash flow. This leaves property owners in significant distress as many properties are no longer producing enough cash flow to pay debt service and operating expenses. As a result, commercial real estate borrowers are seeking relief from their lenders to help minimize the impact of the pandemic. Borrowers whose loans have been sold in the capital markets as commercial mortgage-backed securities ("CMBS") are faced with a unique set of challenges and issues. We have highlighted some of the more important issues below.

The ABCs of CMBS

A CMBS loan is a non-recourse commercial real estate loan that is secured by a first mortgage lien on income-producing real estate, including office buildings, apartment buildings, shopping centers, hotels and industrial properties. Instead of the originating lender holding the loan, or syndicating portions of the loan to other parties, the originating lender securitizes the loan by transferring it to a trust (typically a vehicle known as a real estate mortgage investment conduit or REMIC, which has certain tax

advantages for investors). While the average CMBS deal is described as a "conduit," which consists of a pool of many different mortgage loans, there are also "SASB" or single-asset, single-borrower loans that are securitized (typically a single loan secured by either a single property or by a cross-collateralized pool of similar properties owned by a single sponsor).

Once a mortgage loan is securitized, it is no longer serviced by the originating lender. Instead, the trust retains a third-party servicer to service the loans. In most cases, two loan servicers will be assigned to manage the loan(s) held by the trust. Day-to-day operations (*e.g.*, disbursement of reserves) are typically handled by a master servicer. Once a mortgage loan is in distress (*e.g.*, a maturity date default, monthly debt service is delinquent for at least sixty (60) days or a bankruptcy event has occurred, or the borrower requests a workout and the master and special servicers agree to commence workout discussions), the servicing responsibility will be shifted to a special servicer (known as a "special servicing event"). To make matters even more complex, once a special servicing event occurs, the holder of the majority of the first loss tranche of securities in the CMBS deal typically retains consent rights over most actions taken by the special servicers (subject to certain limitations). In this capacity, the holder of the majority of the first loss tranche is referred to as the "directing certificate holder" in the securitization documents. Borrowers have no consent rights over who is retained as the master servicer or the special servicer, or the identity of the directing certificate holder. Through the securitization process, the originating lender selects the master servicer and the directing certificate holder (although that holder can change if the first loss tranche is sold to another CMBS investor in a secondary market transaction). In most securitizations, the directing certificate holder is entitled to select and replace the special servicer.

The roles of each servicer and the directing certificate holder are governed by a lengthy and complex agreement, known as a "pooling and servicing agreement." These agreements lay out the various rights and responsibilities of a master servicer, special servicer, directing certificate holder and other relevant parties. Borrowers are not a party to these agreements, nor are they entitled to receive copies of them. As a result, there is little clarity provided to borrowers about the authority these parties have to grant debt relief or agree to other loan modifications. All of this makes the workout of CMBS loans complex and uncertain. Borrowers have learned a fair bit about how these loans work as a result of the previous financial crisis and are using that knowledge to their advantage in trying to navigate through workouts necessitated by the COVID-19 pandemic.

Workout Guidance

- *Getting Attention*. Servicers in the best of circumstances are often slow in responding to borrower requests. As a result of the COVID-19 pandemic, master servicers, special servicers and directing certificate holders are inundated with requests for relief, which has only increased their response times. We expect that requests for relief will be multiples of what these parties witnessed during the global financial crisis in 2008. Larger loans (*e.g.*, the top ten (10) loans in a conduit deal) or a loan backing a SASB transaction may have better success in getting a quick response from the relevant party. But given the expected number of loan requests, all CMBS loan borrowers are going to need to be extremely persistent in order to get the attention that they need.

- *Master Servicer's Role*. What is the master servicer's role? It is actually quite limited when it comes to granting relief to borrowers. Master servicers have little to no authority to grant relief from debt service requirements for properties that are suffering due to the COVID-19 pandemic. For loans that are otherwise performing, the master servicer may have the authority to direct the use of reserve funds that are to be used by borrowers to pay property operating expenses or capital requirements or that are being retained in an excess cash flow reserve towards the payment of debt service, taxes and insurance. But pooling and servicing agreements typically do not provide master servicers with the authority to grant any other economic relief.

- *Special Servicer's Role*. As noted above, the master servicer's role in a workout is quite limited. It is only the special servicer (with the approval of the directing certificate holder) who has the power to grant material loan modifications, such as a forbearance or forgiveness of debt and such material modifications may only be granted by the special servicer after the loan has been transferred to special servicing. But there is a catch. Even if a borrower has stopped paying debt service, pooling and servicing agreements often provide that only after the borrower has failed to pay debt service for a period of at least sixty (60) days can the loan be transferred into special servicing. Stated another way, it can take two (2) months following a default for a borrower to even begin discussions with a special servicer about a loan modification. The only other way to begin discussions in earnest with the special servicers is for the borrower to make a request in writing for such a transfer to occur. A typical pooling and servicing agreement requires that in order for such a transfer to occur, the borrower needs to allege in writing that a significant "imminent default" is likely to occur. A few words of caution. First, as discussed in more detail below, a transfer to special servicing typically involves the incurrence of special servicing fees that must be paid by the borrower. Borrowers also need to be particularly careful about the wording used in any notice letter alleging an imminent default in order to

avoid triggering a default under the loan documents or liability under a non-recourse carveout guaranty. More on this issue below.

- *Fees, Fees and More Fees*. Fees may be one of the most important points for CMBS borrowers to understand. Not only can modifying a CMBS loan be a long, drawn-out process, it can also be costly. Special servicers earn their income by charging fees to borrowers in connection with loans that enter special servicing. Once a CMBS loan is transferred to a special servicer, a special servicing fee will be applied to the principal balance of the loan until the loan is no longer a specially-serviced loan. The typical CMBS deal charges a monthly special servicing fee based on an annual rate of 0.25% of the principal balance of the loan. One might think that if a borrower commences paying debt service again or otherwise cures the default, these fees would stop accruing. Unfortunately for borrowers, this is often not the case. The fees stop accruing only when the loan is no longer a specially-serviced loan, which may require that the loan perform again for a certain period of time. Further, even if the parties are ultimately unable to reach agreement on a forbearance agreement or other arrangement, these fees are still payable by the borrower. Moreover, once a loan leaves special servicing (*i.e.*, the special servicer returns it to the master servicer), there is typically an additional special servicing fee that must be paid. For most conduit loans, that fee is 1% of the principal balance of the loan. Typically, these fees are payable solely by the borrower and are not shared by the bondholders. Borrowers generally have no visibility into these fees since they are set forth in the pooling and servicing agreement to which the borrower is not party. Therefore, borrowers need to be very careful about voluntarily transferring the loan into special servicing. Fortunately, given the unprecedented volume of loans anticipated to enter special servicing as a result of the COVID-19 pandemic, we currently expect that special servicers will be potentially willing to negotiate lower special servicing fees. A little known fact about the special servicing fees in CMBS deals is that they are typically split in some fashion between the special servicer and the directing certificate holder. Therefore, any reduction in special servicing fees will need to be agreed upon by both of these parties.

- *Regulatory Requirements*. In order to maintain status as a REMIC and avoid adverse tax treatment, the rules governing REMICs prohibit "significant modifications" to the loan documents. There are certain exceptions to the "significant modification" requirements, but servicers may require an opinion of counsel stating that a modification does not constitute a "significant modification" under the REMIC rules. This adds additional costs and could also impact timing for a CMBS borrower in need of immediate relief. Furthermore, special servicers may require confirmation from a rating agency that the modification will not cause a downgrade of the bond ratings of the underlying securities. Obtaining rating agency confirmations can be an expensive and time-consuming process. Reacting to the issues facing CMBS

borrowers requiring relief due to the COVID-19 pandemic, the IRS issued Revenue Procedure 2020-26 on April 13, 2020. This provides a safe harbor from adverse tax consequences for payment forbearances of three (3) to six (6) months and "related modifications" arising from the COVID-19 pandemic for mortgage loans held by REMICs and may obviate the need for a REMIC opinion. Although the IRS did not define "related modifications" it did provide two examples: (i) adding deferred payments to the principal amount to be paid after what would otherwise be the final payment of the loan; and (ii) re-amortizing an amortizing mortgage loan at the end of a forbearance period to preserve the original maturity date. Future guidance may clarify and perhaps expand the category of modifications that would not trigger adverse tax consequences. Further, at this time, we do not believe that special servicers are seeking a rating agency confirmation in connection with forbearance arrangements.

- *Guarantees*. When communicating with a servicer, the borrower must take great care to avoid breaching the covenants contained in the loan documents and inadvertently triggering recourse liability to the borrower and its guarantor, in particular. For example, typical recourse carveouts include an admission in writing that the borrower is unable to pay its debts as they become due. Additionally, among other things, single-purpose entity covenants typically restrict the incurrence of additional indebtedness, so access to loans issued pursuant to the Coronavirus Aid, Relief and Economic Security Act may require lender consent.

Conclusion

Modifying CMBS loans can be costly and time consuming and there is no guaranty that a satisfactory result will be achieved. Communications with a special servicer may inadvertently trigger recourse liability to a borrower and its guarantor. In addition, a borrower should expect that the special servicer will seek concessions (*e.g.*, a hard lockbox, an excess cash flow sweep, additional leasing covenants, additional financial or property-level tests and budget approvals) in exchange for granting the desired relief. Accordingly, the risks must be carefully considered by a borrower prior to entering into workout discussions with a special servicer.

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For more information regarding the legal impacts of the coronavirus, please visit our Coronavirus Resource Center.

Please do not hesitate to contact us with any questions.

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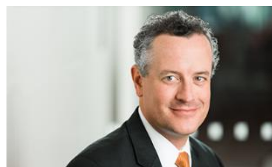

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