



Turning the Page

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Welcoming 2021

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Like everyone else, we have run out of ways to describe 2020. Unprecedented. Stunning. Surreal. Devastating. We know that almost everyone has been impacted by COVID-19 – some more tragic than others. It certainly has been a year that has reminded us of how fragile life is and how thankful we must be for good health.

Last year at this time, we anticipated that 2020 would “continue to be a robust period for real estate and real estate finance, in particular.” We wrote, “There continues to be a great deal of money in the marketplace that is eager to transact, and we continue to see a great deal of demand. We’re very excited about the prospects for 2020 and beyond.”

Fast-forward to where we are today, and it is safe to say that the impact on our industry has been significant, to say the least. Furthermore, we all know all too well that there is no quick fix in sight that will immediately turn things around. While we cautiously see and expect that transactions will continue, there will inevitably be stress in the market, and workouts and restructurings will become part of our new normal for at least the near-term.

Needless to say, we won’t even try to look into our crystal balls and make predictions for 2021. We all believe that the existence of the COVID-19 vaccine means that there is light at the end of the tunnel. We can only hope that once we come out on the other side of this that the industry will stabilize and return to the robust trend of growth in which 2020 began.

Before we close the year, we want to pause to say thank you to Bill McInerney, the co-head of our Finance Group and member of our Management Committee. Bill is retiring on Dec. 31 after almost 30 years at the firm. We will all miss Bill’s trusted counsel, guidance and support, but are so happy for him as he begins a new exciting chapter in his life.

Wishing everyone the best this holiday season and a happy, HEALTHY and prosperous new year.

Take Another B-Piece of My Heart, Now Baby

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In pooled commercial mortgage-backed securities (“CMBS”) transactions, typically called “conduit” transactions, and some single-asset (“SASB”) transactions, a single entity typically purchases one or more classes of certificates that represent the entirety of the first-loss portion of the securitization. This entity is referred to as the “B-Piece Buyer,” because it purchases the unrated and lowest-rated (in conduit transactions, typically “B” or “B-”) classes of the securitization. Additionally, in certain transactions, the B-Piece Buyer also acts as the “third-party purchaser” under the risk retention rules, which permit a sponsor to satisfy its risk retention obligation through the purchase of the first-loss portion of a transaction by an unaffiliated party. Because the B-Piece Buyer has a greater risk of loss than investors in the more senior classes of a CMBS transaction, it has certain rights both before and after securitization that extend much further than the rights granted to the more passive senior investors.

Before Securitization

A CMBS conduit transaction cannot get off the ground without a B-Piece Buyer. Unlike the investors in the other classes of the CMBS transaction, the B-Piece Buyer is identified and generally commits to the deal (subject to certain parameters and qualifications) before servicing parties have been selected, any offering materials have been printed or the pool of loans serving as collateral has been finalized. Once a B-Piece Buyer agrees to be part of a particular deal, the B-Piece Buyer takes an active role in shaping the collateral pool and the terms of the transaction. It conducts an independent review of the credit risk of each loan and has the right to veto loans proposed by the lenders for inclusion in the pool, and its sign-off on the final pool is necessary for the transaction to move forward. If the B-Piece Buyer is acting as third-party purchaser for the transaction, its review also satisfies risk retention requirements: each third-party purchaser conducts an independent review of the credit risk of each securitized asset prior to the sale of the asset-backed securities in the securitization transaction that includes, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each commercial real estate loan that is collateral for the asset-backed securities. In addition, as a condition to joining the deal, a B-Piece Buyer will often stipulate how much of the loan pool can consist of loans secured by certain property types or have similar requirements. The B-Piece Buyer also receives drafts of the servicing documents and negotiates the provisions relating to the control it will have over the pool assets after the securitization closes.

While some SASB transactions also have B-Piece Buyers, they are not ubiquitous as they are in conduit transactions, and a SASB issuer who is not relying on a B-Piece Buyer to act as third-party purchaser may not have a B-Piece Buyer in the transaction at all, in part because the first loss class of a SASB often has an investment-grade rating.

After Securitization

CMBS conduit pooling and servicing agreements provide that, as long as the principal balance of the classes the B-Piece Buyer holds are not reduced below the “control” thresholds described below, they have a set of rights that other certificateholders do not. One of those rights is the ability to provide feedback and approval to any proposed loan modifications or workouts. When a loan becomes specially serviced, the special servicer is required to prepare an “asset status” report describing the current state of the loan and how the special servicer proposes to resolve the loan default. The B-Piece Buyer reviews this report, and the report and proposed plan of action are only final once the B-Piece Buyer approves them, subject to the special servicer’s ability to take emergency action without waiting for B-Piece Buyer approval if it determines that it is necessary to protect the certificateholders from potential harm.

In addition, as long as it has control, the B-Piece Buyer has consent rights over “major decisions.” While the scope of the so-called “major decisions” varies to some degree from deal to deal (and is often negotiated by the B-Piece Buyer prior to the securitization closing), generally any matter in a loan agreement relating to modifications or waivers to the documents or the lender’s exercise of remedies falls within the scope of the B-Piece Buyer’s review and approval.

The special servicer – the servicer specifically responsible for loans that have defaulted or are at significant risk of default (and often an affiliate of the B-Piece Buyer) – is replaceable at will by the B-Piece Buyer as long as the B-Piece Buyer has control rights, and so even special servicer decisions that are not explicitly subject to B-Piece Buyer consent rights can be subject to B-Piece Buyer influence through its relationship with the special servicer.

Changes in Control and Loss of Control

While a B-Piece Buyer's influence over a securitization is significant, it is not necessarily permanent. There are several ways a B-Piece Buyer can lose its control powers and the right to appoint a new special servicer. First, it can sell its certificates. The powers granted under the pooling and servicing agreements are exercisable by whatever entity owns the majority of the class of certificates designated as the controlling class, and so a buyer of that class steps into the B-Piece Buyer's shoes. If the B-Piece Buyer is holding the controlling class as a "third-party purchaser," it is prohibited from transferring its certificates to an unaffiliated buyer, except for a single transfer to an unaffiliated buyer at least five years after the securitization closing date, but the transactions that do not use this risk retention structure have first-loss certificates that can be freely transferred to subsequent investors at any time.

Second, the B-Piece Buyer can lose its control through its affiliations with a borrower party. If the B-Piece Buyer is affiliated with a borrower, a property manager or the holder of a mezzanine loan that has been accelerated or as to which the lender has instituted enforcement or foreclosure proceedings, then the B-Piece Buyer ceases to have control or consent rights with respect to the impacted loan for as long as the affiliation continues.

Finally, a B-Piece Buyer can lose its powers through the application of realized losses to the certificates and the nominal reduction of the balances of its certificates through the application of appraisal reduction amounts. When the aggregate outstanding principal amounts of the mortgage loans are less than the aggregate principal balances of all classes of certificates, the resulting shortfall is applied to reduce the principal balance of each class of certificates, beginning with the first loss class.

Appraisal reductions occur when certain events indicating that a loan is in distress trigger an appraisal of the underlying property, and if the appraisal indicates that the appraised value is lower than the balance of the loan. The classes of certificates are nominally reduced to reflect anticipated losses in the event of a foreclosure, beginning with the first-loss class and moving upward through the classes based on their relative subordination. If the class of certificates previously designated as the controlling class, after having its balance reduced by principal distributions, realized losses and appraisal reductions, has less than 25% of its original principal balance, then control shifts to the first loss class of certificates that still has a control appraisal-reduced principal balance equal to at least 25% of its original principal balance; however, only a small number of the junior classes are so-called "control-eligible" classes, and if none of them has an adequate principal balance, control is shut off entirely.

When control is shut off, the holder of the first loss outstanding class retains limited consultation rights with respect to loan modifications, workouts and major decisions, unless the class balance, as reduced by principal distributions and realized losses, is less than 25% of the original balance, in which case the consultation rights, like control rights, move to the next most subordinate class and if no control-eligible class has a sufficient balance outstanding, are also terminated. When control and consultation are terminated, no class of certificates or individual certificateholder has the right to grant or withhold consent for borrower requests or replace the special servicer without cause, and the master servicer and special servicer have authority to make decisions about the loans on their own in the manner they believe is in the best interests of all certificateholders.

Conclusion

While the B-Piece Buyer for a transaction does not make a loan or become party to the servicing agreement, it is a significant presence in a CMBS transaction, from the determination of which loans will be included in the collateral pool to the decisions of whether to approve borrower requests, how to work out a defaulted loan and who the special servicer will be.

Don't Lend No Hand to Raise No Flag Atop No Ship of Fools: Breach of SPE Provisions by Non-Borrower Exposes Non-Borrower to Potential Tort Liability

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A recent decision of New York's highest court potentially strengthens the ability of lenders to bring suits against third parties for participation in a borrower's breach of single purpose entity/bankruptcy remote loan document covenants.

The case, Sutton 58 Associates LLC, Appellant v. Philip Pilevsky, et al., Respondents, involved a development project in Manhattan's Sutton Place neighborhood. The lender made mortgage and mezzanine loans in the aggregate amount of \$147,250,000 to the owner of the project and its sole member. The loans were not repaid upon maturity, and the lender sought to foreclose under its mezzanine loan. Prior to the scheduled UCC foreclosure sale, the mezzanine borrower filed a voluntary Chapter 11 bankruptcy case, which was followed by the voluntary Chapter 11 filing of the mortgage borrower. In a separate state court action, the plaintiff lender alleged that prior to the bankruptcy filings, defendant Philip Pilevsky caused an affiliated entity to lend the mezzanine borrower \$50,000 to retain a law firm to file a bankruptcy petition, resulting in a breach of the loan document special purpose entity requirements. The plaintiff further alleged that defendants Michael Pilevsky and Seth Pilevsky caused an affiliated entity to transfer three apartments to the mortgage borrower, in violation of the loan document single purpose entity requirements and in order to prevent the mortgage borrower from being a Single Asset Real Estate Business for purposes of the Bankruptcy Code, which would deprive the lender of procedural advantages in the bankruptcy case. The lender further alleged that a Pilevsky entity acquired a 49% interest in the parent of the mezzanine borrower, which also violated the loan documents. Based on the above, the lender sued the Pilevsky defendants in state court for tortious interference with contractual relationships. At the trial court level, the defendants moved for summary judgment on the basis that the lender's claims were preempted by federal bankruptcy law. The trial court denied the motion. The defendants appealed, and the initial appellate court reversed and granted the defendants' motion. The lender then appealed to the Court of Appeals. The Court of Appeals, by a narrow 4-3 majority, held that the lender's tortious interference claims were not preempted, and that these claims could proceed in New York State court.

The majority wrote that federal bankruptcy law does not suggest an intent of Congress to interfere with a state court's authority to provide tort remedies for claims brought by a person that is not a debtor in the bankruptcy proceeding against persons that are also non-debtors in the proceeding for interference with contractual relations that exist independently of the bankruptcy proceeding. The majority noted that the claims against the defendants are based on conduct that occurred prior to the institution of the bankruptcy proceedings, do not raise any question as to the propriety of the bankruptcy proceedings, and do not risk interference with the Bankruptcy Court's control over the debtor's estate.

The dissent, on the other hand, contended that because the plaintiff's claims arise from and seek damages caused by the bankruptcy filings, the plaintiff lender had "recast as state law causes of action what are in fact complaints of bad-faith filings and misuse of the bankruptcy system." In addition, the dissent expressed concern that the majority's decision will affect debtor access to bankruptcy remedies (particularly debtors of limited means) because the prospect of state court litigation may discourage lawyers and secondary lenders from assisting debtors. Accordingly, the dissent concluded that the claims were preempted by federal bankruptcy law and could not be brought in a state court action.

The case did not involve claims under a recourse carve-out guaranty or any other loan documents. The opinion addressed claims by the lender against third parties that, based on the facts recited in the court's decision, appear to have become involved with the project in the context of a distress scenario. The court held that under the circumstances of this case, the Bankruptcy Code did not provide these third parties protection against claims by the lender alleging that they tortiously interfered with the contractual relationship between the borrowers and the lender. Thus, it can be viewed as strengthening the potential remedies that a lender can assert against third parties that introduce themselves into a distress situation and aid the borrower in frustrating lender protections contained in the loan documents. While nothing in the opinions indicate that the Pilevsky defendants had any previous involvement with the borrowers, there is no reason to assume that the court would have ruled any differently if affiliates of the borrowers had engaged in similar actions, which could potentially expose them to liability even though those affiliates themselves might not have been parties to a recourse carve-out guaranty or any other loan documents. It is important to note, however, that the Court of Appeals did not address the sufficiency of the lender's allegations to support a cause of action based on tortious interference, and did not address the prospects of the lender actually prevailing on such claims. It simply held that under the circumstances, the federal Bankruptcy Code did not preclude the lender from bringing such claims in state court, independent of the bankruptcy proceedings.

The facts in this case seem suspicious at best. It was an apparent attempt by a “friend” of the borrower to provide funds to finance the borrower’s fight with its lender and through transactions which were impermissible under the loan documents to prevent a lender from availing itself of the protections of a Single Asset Real Estate Business under the Bankruptcy Code. The transactions orchestrated by the third party were clearly prohibited by the loan documents and arguably were not entered into for an independent business purpose based on standard economic objectives. The transactions seem more likely to have been driven by the impact they would have on the borrower’s distressed situation and its “fight” with its lender. It is unclear whether this third party was looking to capitalize on a distressed situation and end up a majority owner of the asset down the line – however, others should be cautioned by the ramifications of this decision. This decision is a welcome result which may deter other third parties from allegedly aiding and abetting borrowers in violating bargained-for restrictions in their loan documents.

Hotel Financing Series, Part 6: Cash Control

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Running a hotel is a complex business. There are constant streams of different types of cash inflows and outflows, as well as reserves required for a capex-heavy business. In this final part of our hotel financing series, we look at some of the typical cash structures and some of the control measures lenders put in place.

In a typical hotel operating structure, the hotel manager operates the main hotel account, which collects all the hotel revenues as well as the day-to-day expenditure. There may be several different accounts required for the operations, as there may be separate accounts for suppliers, staff payments and so on. These accounts could be solely operated by the hotel manager or operated jointly with the hotel owner.

The hotel manager then transfers the gross profit on a periodic basis to the owner's account. The practice here usually starts to diverge. In some instances, the hotel manager deducts all the franchise fees and hotel management fees and other associated costs before making this transfer, and in some instances, no deductions are made and the hotel owner needs to separately account for these fees.

There are many different ways in obtaining security and control over the cash accounts. The first key question for a lender is to examine the inflows and outflows of the particular hotel and at what level should the control be exerted. If the control mechanics are too tight, it may hinder the operations of the hotel. Too loose may provide plenty of scope for cash to leak out of the structure. For example, costs and expenses that are essential to the day-to-day running of the hotel should be paid as a priority, and any restrictions on these kept to a minimum. Often the amount required for debt servicing will have to come out after these essential costs have been paid, as otherwise, the hotel may be devalued if the business is not operating with sufficient cash. Some lenders provide free rein with a floating charge on the operating account so long as there are frequent reporting and financial reports. Other costs which must be paid are generally amounts payable under the franchise agreement and certain hotel management costs, as failure to pay these would give rise to termination of the franchise agreement and/or HMA, which impacts the value of the hotel.

The dynamics between the need to meet hotel operation expenditures and debt service has been put under the spotlight this year. As a result of the COVID-19 pandemic, this year has been a difficult year for the hotel industry, to say the least. With hotels being mandated to close, or having to run at minimum capacity, it has been difficult for hotel owners to manage cashflows and make meaningful projections, given that revenue streams have been destabilised. Many borrowers have requested the banks to suspend certain financing payments during this time or even enter into standstill arrangements with respect to financial covenant/payment defaults in order to preserve cash to meet necessary expenditures throughout this period. One of the key issues to be decided between the bank and the borrower is to ensure that, whatever cash is left in the structure to meet necessary expenditures, such cash reserves are justified on a line-by-line basis, and that whilst payments are suspended and/or financial covenants are not met, there are controls around ensuring that the cash is used for the agreed purpose to minimise any risk of leakage.

In addition to the operating accounts, usually (in the ordinary course of hotel operations) there is a separate dedicated capital expenditure account which maintains cash reserves allocated to maintenance of the hotel and also ongoing upgrades to adhere to brand standards. Lenders may want to impose capex restrictions (e.g., an annual cap, or in accordance with an agreed budget) and require any capex expenditure to come out of this account so that the cash in the other accounts would not be affected.

Sometimes it is not possible for a lender to obtain the most ideal cash control position due to the way the account structure is set up. It is therefore very important for the lender to keep a close eye on the financial reporting, which covers periodic revenue and expenditure, as well as projected expenditures, so that any major expenditures should be withdrawn and spent in accordance with the approved plans as much as possible.

Due to the cyclical nature of the business and the cashflows, another method which lenders use is the requirement to provide cash collateral by the sponsor, or set a minimum surplus amount on the debt service account, so that there will be some buffer which could be drawn against to service the debt during any period when cash may be a bit tight.

Finally, where the bank accounts are held with another financial institution, the lender may wish to enter into an account control arrangement with the account bank to assist with quick access in controlling the account and the cash when exercising enforcement rights.

We hope you found this six-part hotel financing series informative and useful, and we are of course available to answer any questions or provide any support.

Recent Transactions

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Here is a rundown of some of Cadwalader's recent work on behalf of our clients.

Recent transactions include:

- Representation of the administrative agent and lender in the \$150 million refinance of a Class A life sciences laboratory building located in the Seaport District in Boston.
- Representation of co-lenders in the \$358 million refinance of 139 buildings and nearly 7,000,000 square feet of McClellan Park, an office and industrial park in Sacramento County, California. McClellan Park was formerly McClellan Air Force Base, one of five main depots in the United States that provided repair and maintenance services to military aircraft.
- Representation of the administrative agent and lender in a \$100 million refinancing of two distribution centers tenanted by a large bulk foods distributor.
- Representation of the lender in connection with a \$167.7 million mortgage loan to finance the acquisition of two Class A office buildings in San Jose, California, and which serve as the headquarters for media company Roku.
- Representation of the lenders in the \$705 million mortgage and financing of the 410 Tenth Avenue office building in New York City.
- Representation of the lender on multiple financings aggregating approximately \$200 million for a single sponsor secured by hospitality, office and retail properties across the United States.
- Representation of the lender in a \$200 million financing facility initially secured by 16 self-storage facilities, with capacity to add on additional properties pursuant to an aggregation facility.
- Representation of facility purchaser in connection with the origination of a revolving credit facility in the initial principal amount of up to \$100 million, subject to expansion up to \$150 million, to finance the acquisition and re-positioning of multifamily properties.