Expert Q&A on Developments in CMBS Lending

The commercial mortgage-backed securities (CMBS) lending market has, by all accounts, experienced a complete turnaround since its implosion in the years following the 2008 financial crisis. CMBS lending is now back and facing new challenges in a booming market. Practical Law asked *William McInerney* and *Fredric Altschuler* of *Cadwalader, Wickersham & Taft LLP* for their thoughts on how CMBS lending has changed in recent years and the ways they are tailoring their practice to the demands of the current CMBS market.

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The current wave of CMBS lending has been referred to as both "CMBS 2.0" and "CMBS 3.0." What distinction do you think people are trying to draw by using CMBS 3.0, and do you think it is justified?

CMBS 3.0 was a term that was used by a few originators and others in the securitization community for a very short period, with the primary distinction being more restrictive subordination levels (that is, investment-grade and non-investment-grade credit ratings assigned to classes of bonds backed by the securitized loans). The term has not had much traction and is rarely, if ever, still being used. Most securitization experts continue to be of the view that we remain in a CMBS 2.0 world.

Search Commercial Mortgage-backed Securities (CMBS) Finance: Overview for a detailed explanation of CMBS finance.

Regardless of whether you call it CMBS 2.0 or CMBS 3.0, there is no doubt that the current market is different from CMBS 1.0 (CMBS lending as it was practiced before the 2008 financial crisis). What are some of the major legal differences between pre-crash and post-crash deals?

The most obvious distinction is probably stricter underwriting by the loan originators, coupled with an effort to simplify the structures. For loan originations, since the financial crisis, very few loans have had more than two layers of mezzanine debt (loans secured by a pledge of the direct or indirect equity in the owner of the property (the mortgage borrower)). Before the financial crisis, four and even five layers of mezzanine debt were common.

Search Mezzanine Loans in Commercial Real Estate Finance for an overview of the purpose, structure and documents of real estate mezzanine loans.

Another difference is loan documentation is considerably more "lender favorable." This includes more "hard" cash management systems that give the lender control over the property's cash flow from day one, as well as frequent cash trap triggers relating to matters such as loan-to-value and debt service coverage ratios and debt yield tests that allow the lender to hold excess cash as additional collateral rather than releasing it to the borrower. Reserves are now the norm for tenant improvements, leasing commissions and capital expenditures, including upfront reserves for vacant and unleased space.

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Bad acts guaranties are now institutionalized with full recourse (meaning, the guarantor becomes responsible for repayment of the entire loan, as opposed to simply indemnifying the lender for losses) for items like voluntary or collusive involuntary bankruptcy, transfers in violation of the loan documents and breaches of the borrower's single purpose entity covenants. In addition, many guaranties now provide for financial covenants relating to net worth and liquidity, which were not as prevalent in CMBS 1.0. Notably, however, there seems to be distinctions made regarding the quality of the sponsor and borrowing entity, with larger institutional owners and investors receiving more favorable provisions than conduit (smaller loan balance) borrowers.

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On the securitization administrative side, probably the two most significant changes in pooling and servicing agreements have been:

- The appointment of an operating advisor (which did not exist in CMBS 1.0) to supervise the special servicer as a representative of the interests of the bondholders as a whole.
- More restrictive provisions with respect to appraisal reduction and control.

There are many new CMBS lenders competing for business in today's booming commercial real estate market. Do you see any danger of the post-crash protections being eroded as these new lenders bid for market share?

The changes that were added in CMBS 2.0 will, in all likelihood, remain. However, there is surely a concern among the more seasoned and established loan originators that the addition of so many new participants in the business will result in an erosion of both underwriting standards and the loan documentation provisions that provide additional comfort to lenders (such as those described above). Borrowers, being resourceful, have and will continue to attempt to take advantage of this and bargain for greater flexibility, likely using some of the newer players to accomplish this objective.

For example, we have recently seen many more loans where the liability of a guarantor for certain of its "bad acts" has been capped at a percentage of the loan amount (typically between 15% and 20%). Limitations on liability previously existed but typically were only obtained by the strongest of borrowers with the greatest leverage.

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Search Trends in Nonrecourse Carveout Guaranties in Commercial Real Estate Loans for recent developments in nonrecourse carveout guaranties.

Given that the real estate market moves cyclically, how are you drawing on your experience with the defaults, workouts and foreclosures that occurred in the aftermath of the 2008 financial crisis to prepare your clients for the next downturn?

Hopefully, the 2008 financial crisis was a once in a lifetime event. However, there will be market disruptions in the days ahead (for example, Greece's debt crisis and volatility in Chinese stock markets). These types of disruptions do make it difficult to price debt at times and some lenders could be quickly hurt. Generally, interest rates are on the rise and this must be taken into account.

We do believe that most institutional lenders are now and will remain more disciplined, at least in the short term. Many seem to be showing more interest in quality over quantity. A loan will go into default for many reasons, but rarely will a loan document provision be the driving cause for the default. We have seen very few, if any, loans that have been originated in the post-crash period that do not "cash flow" at loan origination. Hopefully, the term "interest reserve" will not return to the vernacular.

Many attorneys who lived through the defaults, workouts and foreclosures would argue that things would have been much worse but for the existence of bad acts guaranties. There is little doubt that many more borrowers would have taken advantage of the bankruptcy laws and used the threat of bankruptcy as leverage in negotiating a workout but for a significant sponsor liable under a guaranty. Many guaranties also contained provisions making the loan fully recourse in the event the borrower interfered or impeded a lender's exercise of remedies. Accordingly, if we could stress only one thing to our clients that we learned from the 2008 financial crisis, it would be to continue their insistence on guaranties.

Search Borrower Defaults and Lender Remedies in Commercial Real Estate Loans for more on defaults and foreclosures.

Over the last couple of years, a huge volume of international capital has been pouring into US commercial real estate. Has the presence of such a large number of foreign investors, many of them first-timers in this market, changed anything about how you and your clients negotiate and close deals, from either a business or legal perspective?

From a business perspective, much of the foreign investment has taken the form of equity infusions with no day-to-day managerial role (other than approval rights over major decisions if the equity investment is substantial). Accordingly, the client's focus has been more on Know Your Customer regulations, Office of Foreign Assets Control (OFAC) and PATRIOT Act compliance, rather than on operational or property-specific issues.

In terms of legal considerations, in addition to being sensitive to OFAC and PATRIOT Act concerns, much greater scrutiny is given to the ownership structure and the transfers of equity permitted under the loan documents. In addition, if a foreign investor directly or indirectly owns all or substantially all of the borrower and controls the borrower, from a business standpoint, the client needs to understand management and become comfortable with the expertise of the borrower's sponsors in owning and managing commercial real estate assets. For example, the identity of the third-party management company takes on more significance.

Search USA PATRIOT Act and Know Your Customer Requirements for Lenders for guidance on complying with these regulations.

On the legal side, you mentioned the critical importance of guaranties. Have you found that foreign investors, such as sovereign wealth funds, push back harder against personal liability for bad acts? What recommendations do you make to your clients regarding the potential difficulties involved in enforcing judgments against foreign guarantors' non-US assets?

If the guarantor is a foreign entity or if the assets of the entity are largely offshore, issues such as consent to jurisdiction, enforceability of the guaranty, and any judgment obtained on the guaranty in the jurisdiction of formation of the guarantor or the jurisdiction where much of the guarantor's assets are located must be analyzed. Further, legal opinions from those jurisdictions should be obtained. While most sophisticated US lenders understand this, since the enforcement mechanisms vary from country to country, it is critical that the client be made aware of these issues.

On the business side, what steps do you see your institutional lender clients taking to keep CMBS debt competitive with foreign banks as a funding source?

Ultimately, a borrower will look at two things:

- Amount of proceeds.
- The interest rate.

This has been true since the inception of CMBS. In the early years of CMBS, CMBS lenders were able to provide better terms than commercial banks, savings and loan associations and insurance companies, and on a quicker closing track. In addition, CMBS filled a void left by banks and insurance companies, which were largely on the sidelines as CMBS evolved.

To the extent that foreign lenders can win the "pricing wars," they will see their market share grow. To date, we have seen foreign lenders more active in the syndicated loan market as part of a larger bank group but not necessarily the administrative agent. This may change in the near future as foreign lenders become more comfortable with US real estate. To remain competitive, US lenders will continue to stress their track record of performance, such as certainty of closing and familiarity with US real estate markets.

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