

FACTUAL BACKGROUND: THE COMMERCIAL MORTGAGE-BACKED SECURITIES INDUSTRY

Commercial mortgage-backed securities are bonds offered to investors that are collateralized by a pool of commercial mortgage loans from which all of the principal and interest paid on those mortgages flows to investors. To create these investment vehicles, mortgage loans of varying dollar amounts, property type, and location —and containing a myriad of individualized terms and conditions — are pooled and transferred to a trust. Bonds then are issued backed by the pool of assets held in the trust. Those bonds vary in yield (the amount of return on the bonds), duration (the length of time before the bond is expected to be paid off), and payment priority (the order in which investors are paid a return on their investment).

Borrowers, lenders, and investors all benefit from CMBS. Borrowers often benefit via access both to larger pools of capital than would otherwise be available in traditional lending markets and to lower interest rates. Lenders benefit from CMBS because the securitization enables them to access the capital markets with their loan products and to obtain new bonds to make new loans. Investors benefit because CMBS creates a potentially attractive and credit-worthy investment vehicle that caters to their desired risk profile, investment term, and yield. The steps in a commercial real estate finance transaction, from the negotiation of the individual mortgage loan through the creation and administration of the corresponding commercial mortgage-backed securities, are outlined below.

A. The Lender and the Borrower – The Initial Loan

The starting point of the entire CMBS transaction is an individually negotiated commercial mortgage loan. Unlike the typical mortgage that an individual obtains in connection with the purchase of a home, commercial mortgage loans are non-standardized. A residential mortgage typically uses standard loan documents – that are not modified or negotiated – on forms created by Fannie Mae or Freddie Mac. For commercial real estate, the loan documents are separately and extensively negotiated for each and every loan between the parties and their respective counsel, and for good reasons. First, there are many types of commercial real estate that serve as the collateral for the loan that vary both by type of project – apartment buildings, hotels, shopping malls, office towers, and warehouses, for example – and by location, encompassing properties located in dense urban areas, seaports, suburbs, and more rural locales. These variations result in loan structure differences concerning escrow requirements, tenant reserves, property management criteria, lease approvals, and, of course, prepayment terms. Second, the payments of principal and interest are expected to be paid out of the income generated by the use of the real estate that provides the collateral for the associated loans. Third, the borrowers typically are sophisticated and have very different needs and requirements in their respective loan situations. They are legal entities, such as corporations or partnerships, and usually are represented by counsel who advises them throughout the lending process.

B. The Issuer and the Trust – Structuring and Pooling the Loans

The individually negotiated commercial mortgages are the building blocks of the commercial mortgage-backed security, and the “issuer” is the architect. The issuer gathers together the loans that are to be securitized and then defines the classes of bonds that are offered to investors. The issuer typically is an investment bank that evaluates and aggregates the loans for the CMBS trust and submits summaries of the loans in electronic spreadsheet form and hard copy text to the rating agencies so that they can be evaluated.

For CMBS, a key responsibility of the issuer in structuring the investment vehicle involves aggregating the loans – a process referred to in the industry as “pooling” the loans. In selecting the loans for the pool, the issuer strives to create a desired mix of loans to produce an attractive investment opportunity for investors. In some cases, the pool contains loans that are highly diverse in terms of industry, size, type, and location; in other cases, the pool contains a more homogenous collection of loans. The purpose of such varied pools is to offer investors a variety of choices along a risk-return spectrum.

The issuer creates a trust to hold the pool of secured commercial mortgage loans and appoints a trustee to hold the loan documents and to oversee the distribution of payments to investors. That trust generally is structured as a statutorily-created holding entity known as a Real Estate Mortgage Investment Conduit (“REMIC”). REMICs were authorized by Congress in the Tax Reform Act of 1986 to allow trusts that satisfy the REMIC requirements to issue multiple classes of securities backed by the trust assets (here, commercial mortgage loans) without any adverse tax consequences to the trust.¹ The REMIC framework enables the trust to hold the loans that are secured by real property without the regulatory, accounting, and economic obstacles that exist in other forms of mortgage-backed securities. REMICs are analogous to limited partnerships or limited liability corporations in that they are created to allow an entity to pass through its income and its liabilities directly to its investor beneficiaries. The REMIC trust itself generally pays no tax on the income generated by the trust assets; instead, taxes are paid only by the individual investor(s) holding the residual interest(s) in the REMIC. In exchange for such favorable tax treatment, the applicable rules require the REMIC to operate as a holding entity for an unchanging (or “static”) pool of loans, except when a loan is in default. If modifications are made to a securitized loan that is not in default, the REMIC runs the risk of being viewed as a business entity rather than a holding entity, and thus may be required, for example, to pay entity-level taxes.

From the pooled loans in the trust, the issuer defines different classes of bonds to be secured by the pool of mortgage loans. The specifications for such classes of bonds then are submitted to a rating agency which in turn rates each class of bonds.

¹ See Pub. L. 99-514, 100 Stat. 2309 (1986), codified at 26 U.S.C. § 860A et seq.

C. **The Issuer and the Rating Agencies — Rating the Bonds**

An indispensable part of structuring CMBS involves submitting the bonds secured by the individual loans to one or more rating agencies. Rating the bonds is the linchpin of the securitization process because the ratings serve as unbiased third-party opinions on the quality of each bond in the structure. To obtain the ratings, the issuer submits the proposed pool of loans to the rating agencies, which establish bond ratings for each class of bonds by examining certain specific terms of each underlying individual commercial mortgage loan.

To establish a rating for each class of bonds, the rating agencies thoroughly review a large number of critical characteristics of each of the loans in the underlying pool and assign a credit rating to each bond class based upon that evaluation. This analysis includes an examination of the volatility and reliability of the cash flows associated with the property; the type, quality, and competitiveness of the property; the experience and reputation of the borrower and manager; the location of the real estate; the quality of the tenant; and the key terms of the loan agreements themselves — including the prepayment terms.²

In conducting this evaluation, the rating agencies generally do not examine the loan documents themselves, but instead rely on detailed summary information submitted in standardized formats. To support that submission, issuers also are required to provide assurances in the form of representations, warranties, and covenants. For example, the following representations and warranties normally are provided:

- “None of the terms of a mortgage loan have been impaired, waived, altered or modified in any way, except by written instruments all of which are included in the related mortgage file”;³ and
- “The mortgage note, mortgage and assignment of leases for each mortgage Loan contain customary and enforceable provisions for commercial mortgage loans secured by properties such as the mortgaged properties, so as to render the rights and remedies of the holder adequate for the realization against the mortgaged property of the benefits of the security, including realization by judicial, or if applicable, non-judicial foreclosure subject to the effect of bankruptcy and similar laws affecting the rights of creditor and the application of principles of equity.”⁴

These are but two provisions on a long list of standard representations and warranties regarding the loans, the property, the borrower, and the authority and solvency of the participants in the transaction. Other representations and warranties address, *inter alia*, the enforceability of the individual loan documents, the maintenance of escrows and

² For a thorough discussion of the CMBS rating process, see David W. Forti and Blase B. Iaconelli, **Commercial Mortgage Backed Securities and the Rating Agency Process**, available at http://www.dechert.com/eventspubs/eventspubs.jsp?pg=lawyer_publications_dctail&id=1729

³ CMBS Basic Overview, *The Rating of Commercial Mortgage-Backed Securities*, available at <http://www.cmbs.org>

⁴ *Id.*

prepayment terms, and compliance with environmental laws and regulations applicable to the underlying properties.⁵

Based on a careful evaluation of the business and contractual terms of the underlying loan agreements and of the representations and warranties, the rating agency assigns a rating to the bonds.

D. The Investor's CMBS Investment

After they are rated, the securitized bonds then are offered to investors. Typically, CMBS investors include life insurance companies, pension funds, money managers, mutual funds, and commercial banks. These investors, in turn, represent millions of individual investors who have entrusted these entities with their savings, retirement monies, and other investments. Borrowers make principal and interest payments on the loans and, from those payment streams, disbursements are made to each class of investors in what is known as a "waterfall" payment sequence, meaning the payments cascade downward from the highest-rated bondholders to the lowest-rated, bondholders. The holders of the highest-rated class of bonds are paid off first.

Bondholders who have acquired lower classes of bonds then are paid off in turn. The investment risk derives from the fact that some of the mortgages in the pool may not perform as expected. As the losses accrue, they are charged upstream to the bondholders, with the lowest grade bondholders bearing the loss initially. By dividing bonds into classes, different types of investors can manage their exposure to real estate risk by selecting their position on the waterfall, based on how much risk they wish to bear – the higher the rating, the lower the risk and the lower the interest rate.

E. The Servicer – Enforcing the Terms of the CMBS Loans on Behalf of the Trustees

An indispensable player in the CMBS market is the servicer. The servicer acts on behalf of and for the benefit of the bondholders and the trust to ensure the continued performance and viability of CMBS by servicing the mortgage loans that constitute the collateral for the bonds. The responsibilities and obligations of the Master (or lead) Servicer are set forth in a Pooling and Servicing Agreement ("PSA") that the Master Servicer enters into with the trustee and commonly includes the obligations to:

- collect mortgage payments and transfer the collected funds to the trustee, who distributes them to the certificate holders;
- advance any late payments to the trust;
- provide mortgage performance reports to bond holders;
- refer all loans that are in default or likely to soon be in default to a "Special Servicer" which develops and implements strategies for such troubled mortgage loans; and
- interpret and enforce the specific contractual terms of each loan in the pool.

⁵ Other participants to the transaction (other than the borrowers) also are required to submit representations and warranties related primarily to their promises to perform their obligations with respect to the CMBS going forward.

The individual terms of each mortgage loan thus explicitly take precedence in the servicing of the mortgage loan over the terms of the PSA in order to uphold the integrity of the contract between the borrower and the lender.