

Real Estate Bulletin

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What is a Conduit Loan? by Glenn A. Fuller Esq.

Overview

CMBS ("Commercial Mortgage- Backed Securities") have become a major capital source for commercial real estate. For the purposes of this paper, we will focus on the type of CMBS transaction that is most common - the scenario wherein a lender makes a loan in the ordinary course of business to a borrower, and then the lender, usually in conjunction with a mass sale of loans, sells the loan to a "conduit" which, in turn, sells securities (in the form of bonds) in the capital markets. This structure has enabled financial institutions to shift risk from their balance sheets to the capital markets, recapture the loan proceeds and thus have increased liquidity to make new loans. As such, CMBS financing provides opportunities for lending institutions to make a much larger volume of loans than if the lending institution had to rely on its deposits as a funding source.

This is not to say that lending institutions no longer originated and hold loans on their balance sheet through maturity (usually called "Portfolio Loans"). Indeed, for the reasons set forth herein, the characteristics of most construction and development loans make them ill suited for the CMBS market. In addition, the substantial restraints on borrowers ability to modify, prepay or otherwise custom a loan designated for the capital market make many loans ill suited to be designated as conduit loans.

Most borrowers and other real estate professionals involved in CMBS transactions (including brokers, bankers and counsel) do not understand the CMBS

process, which can lead to significant confusion and frustration during the loan origination and documentation process (especially in connection with requested modification of loan documents). For instance, substantial legal fees can accrue to a borrower if its counsel does not understand what changes can be made to loan documentation destined for CMBS and what cannot be made. This can lead to borrowers become unnecessarily embittered with their lenders believing that the lender is being unnecessarily inflexible.

What is "Securitization"?

From the borrower's prospective, a loan destined to be securitized looks much like another loan secured by real estate. The documentation presented to the borrower will consist of a note, deed of trust, assignment of leases, security agreement and UCC statement. A significant deviation from the "normal" loan process will be the requirement in most cases that the borrower execute a "lock box" or similar agreement. In addition, all borrowers must be a single purpose entity.

During the "securitization" process, mortgage loans of varying size, asset class type and location are pooled and transferred to a trust. Loans can be transferred directly to the trust or "warehouse" with other loans until a critical mass of loans exist. The trust will prepare a series of bonds based on the loan pool with an income stream that can vary in yield, maturity and payment priority. A credit agency will review the loan pool and issue a credit rating for the

various bonds varying from "investment grade" (AAA/ Aaa through BBB-/Baa3) to below investment grade (BB+/Ba1 through B-/B3) to unrated depending upon the various factors as identified by the credit agency. The bonds are priced according to their level of risk and sold in the capital market.

Investors will assess the appropriate risk/reward threshold that is appropriate for their needs and purchase the bonds in the capital market. Each month the interest received from all of the pooled loans is paid to the investors in the form of a "waterfall" starting the highest rated bonds being paid first, the holders of the next "tranche" of bonds (with the lower rating) being paid next and so forth until all interest on those bonds are paid. If there is a shortfall (or if the collateral is liquidated and does not generate sufficient proceeds to meet payments in all bond classes), the investors in the higher bond classes will be paid first the investors holding the lowest rates bonds will absorb the loss.

The REMIC

The typical "vehicle" for all of this to take place is through an entity called a Real Estate Mortgage Investment Conduit ("REMIC"). A REMIC is a trust structured to be a "pass-through entity" that is not taxed on formation or as a result of income produced by the assets held by the trust. As such, the funds pass from the borrower, to the REMIC and then to the investor (bond holder) without the bond holder being subject to "double taxation". The preservation of the pass-through taxation aspect of CMBS transactions

is vital since the investors' investment decision is priced based on the REMIC will not be taxed and the investor will receive the funds from the REMIC without taxes having been deducted. As a creation of tax law, therefore, compliance with the IRS regulations related to REMICs is essential. This factor (combined with others mentioned herein) makes it extremely difficult to modify and work out CMBS loans.

For instance, the Internal Revenue Code ("Code") provides that "substantially all" of the assets held by a REMIC must be "qualified mortgages" or "permitted investments," as defined by the Code. In order for a loan to be deemed a "qualified mortgage," it must be secured by real property that has a value of at least eighty percent (80%) of the loan balance. The Code and applicable treasury regulations deems "significant modifications" to be an exchange of the obligation originally pledged to the REMIC, since all loans must be contributed to the REMIC within three (3) months of the formation of the REMIC. A "significant modification" is defined as:

(i) [A] modification is a significant modification only if, based on all the facts and circumstances, the legal rights or obligations that are altered are economically significant." Treas. Reg. § 1.1001-3(e)(1); and

(ii) In making a determination [as to whether a modification is significant], all modifications to the debt instrument ... are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant." Treas. Reg. § 1.1001-3(e)(1).

The Code gives the following examples of significant modifications:

Change in Yield

A change in yield on a fixed yield instrument is a significant modification if the yield varies by the greater of 25 basis points or five percent (5%) of the annual yield on the unmodified instrument.

Change in Timing of Payments

A change in the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a "significant modification" if it results in a "material" deferral of the scheduled payments. This can occur as a result of the extension of the maturity date or a deferral of payments at maturity. There are various factors that are considered in determining if a deferral is "material" including the length of the deferral and the amount deferred.

The Treasury Regulations provide certain "safe harbor" modifications that, if they occur, will not result in a "significant modification." These include:

> Deferral of one or more scheduled payments within the "safe-harbor" period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the "safe-harbor" period; provided, however, that deferrals of de minimus payments do not have to fall within the safe harbor requirements.

> The "safe-harbor" period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five (5) years or fifty percent (50%) of the original term of the instrument.

> The "term" does not include any option to extend the original maturity; and

> If the period during which payments are deferred is less than the full "safe-harbor" period, the unused portion of the period remains a "safe-harbor" period for any subsequent deferral of payments on the instrument.

Changes in timing may also affect yield; and both tests must be satisfied independently.

Change in Obligor or Security; Affect on Significant Modifications

> Substitution of new obligor on a recourse debt instrument is a significant modification, however, the substitution of a new obligor on a non-recourse debt instrument is not a significant modification.

> The addition or deletion of a coobligor on a debt instrument is a significant modification if the addition or deletion results in a change in payment expectations.

a. A "change in payment expectations" occurs if, as a result of a transaction:

i. There is a substantial enhancement of the obligor's capacity to meet payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or

ii. There is a substantial impairment of the obligor's capacity to meet payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

> Change in security or credit enhancements:

a. Recourse Debt. A modification that releases, substitutes, add or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations.

b. Nonrecourse Debt. A modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations.

c. Substitution of Collateral. However, a substitution of collateral is not a significant modification if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant.

> Change in Priority. A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations.

> Change in Nature of Debt.

a. A modification of a debt instrument that results in an instrument or property right that

is not debt for federal income tax purposes is a significant modification.

b. A change in the nature of a debt instrument from recourse to nonrecourse is a significant modification. A change from nonrecourse to recourse is a significant modification.

The following are not significant modifications:

> The following changes in the terms of an obligation are not significant modifications regardless of whether they would be significant modifications under Treas. Reg. § 1.860G-2(b)(2).

a. Changes in the terms of the obligation occasioned by default or a reasonably foreseeable default;

b. Assumption of the obligation;

c. Waiver of a due-on-sale clause;

d. Waiver of due on encumbrance clause; and

e. Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage.

> Modifications occasioned by Borrower's default or reasonably foreseeable default:

a. Considerable flexibility is afforded when a loan is in default or at risk of becoming in default. A loan modification "occasioned by" the borrower's "default" or "reasonably foreseeable default" does not cause an adverse REMIC event.

b. Under those circumstances, the loan would continue to be a "qualified mortgage" even though the change otherwise would result in a "significant modification" under Treas. Reg. § 1001.

c. The REMIC rules promote proactive handling of troubled loans by permitting almost any lawful step to realize value for the investors.

d. Determining whether the borrower is "in default" may be objectively verifiable.

e. Determining what constitutes a "reasonably foreseeable default" requires a judgment based on factual circumstances and other factors.

i. The Treasury Regulations provide little guidance for those seeking to interpret the meaning of "reasonably foreseeable default."

ii. One possible test: The economic situation facing the borrower at the time of the borrower's modification request indicates that the borrower and the property will be unable to support the loan in the foreseeable future without a significant and unanticipated change in economic circumstances.

iii. Most services do not require that the default be imminent nor impose a strict timing requirement. A "reasonably foreseeable default" may be a few or many months away. The critical test may be whether a nexus exists between the modification and the potential default (i.e., that the modification is truly "occasioned by" the potential default).

The Pooling and Servicing Agreement

All loans subject to a REMIC are serviced in accordance with a document called a Pooling and Servicing Agreement ("PSA"). The terms of the PSA will be drafted to ensure that the REMIC complies with all IRS regulations to ensure that the REMIC preserves its pass-through tax status. As such, it is essential that the loan documents themselves have servicing provisions that do not conflict with the PSA since the PSA will impose substantial constraints on the ability of the Services to undertake certain actions. In addition to the REMIC requirements relating to maintenance of the REMIC as a tax advantaged status, PSA will be drafted to ensure that the trust complies with the requirements of the rating agency.

The PSA will also set forth the provisions for allocation and distribution of proceeds to the holders of the bonds. All "servicers" under a CMBS (primary, master and special) must comply with the "servicing standard" set forth in the PSA. Although the definitions may vary slightly from deal to deal, the servicing standard requires each servicer to

use the same care, skill and diligence as it uses to service and administer comparable mortgage loans on behalf of third parties or on behalf of itself, whichever is the higher. A typical "Servicing Standard" is as follows: The same manner in which and with the same care, skill, prudence and diligence with which the Master Servicer or the Special Servicer, as the case may be, services and administers similar mortgage loans for other third-party portfolios, giving due consideration to customary and usual standards of practice of prudent institutional commercial mortgage lenders servicing their own mortgages loans and to the maximization of the net present value of the mortgages loans; or the care, skill, prudence and diligence the Master Servicer or the Special Servicer, as the case may be, uses for loans which it owns and which are substantially the same as the Mortgage Loans, giving due consideration to the maximization of the net present value of the mortgage loans.

"Primary" Servicer (Also called the "Sub-Servicer")

This can be the lending institution that that originated the loan. The Primary Servicer is the one with direct contact with the borrower. While the Master Servicer maintains all of the responsibilities and duties to the trust under the PSA, in many instances the Master Servicer and the Primary Servicer will enter into a sub-servicing agreement with similar servicing provisions under the PSA. As such, the Primary Servicer's role becomes almost ministerial in nature and is subject to the same servicing standard as the Master Servicer.

This aspect of the CMBS process can be the most disconcerting to most borrowers since the entity to whom the borrower is likely to have the most contact (and understand the borrower's needs and project the best) is the party with the least power to aid the borrower in any workout or similar situation.

Master Servicer

The Master Servicer will service the loans in the REMIC pool in the ordinary course of business. The Master Servicer manages the flow of payment and the information and

is responsible for the ongoing interaction with the performing Borrower. The Master Servicer is responsible for collecting the payments from the Borrower, holding and making any disbursements from escrows and performing most routine loan administration functions. The Master Servicer is also responsible for collection and analyzing rent rolls, operating statements and other financial and property information from the Borrower, as well as conducting periodic physical inspections (these functions are generally handled by different departments within the Master Servicer's organization or through sub-servicing agreement with a subservice).

The Master Servicer is generally required to process all Borrower requests related to consents, waivers, and modifications related to performing loans. The Master Servicer's ability to waive, consent or modify terms of any mortgage loan is governed by the PSA. "Material" servicing requests or modifications will also require the consent or approval of the Special Servicer. In some cases those decisions are further subject to approval by the Directing Certificateholder or review by Rating Agencies.

In order to protect the income stream of the conduit, the Master Servicer is required to make advances of unpaid principal and interest due under the underlying loan documents. In addition, the main compensation received by the Master Servicer is the "float" on funds received by the Master Servicer from borrowers. The actual "servicing fee" charged by the Master Servicer is very low and is often less than 1 basis point of the balance of loans.

Special Servicer

Certain loans that are in default or if a default is deemed imminent due to the circumstances (a "Special Servicing Event"), the servicing of such loans is transferred to the "Special Servicer," the Special Servicer is in charge of loan workouts, foreclosures and managing properties after foreclosure ("REO" Properties).

The Special Servicer often has or is affiliated with an entity with a substantial interest in the REMIC Trust and is sometimes selected

by the Directing Certificateholder. Like Master Servicer, the Special Servicer has a duty to the trust and is subject to the serving standard. The standard usually mandates that the Special Servicer must act to maximize the recovery on the mortgage loan to the bondholders (as a collective whole) based on an analysis of collection alternatives using a net present value methodology. The Special Servicer will consider multiple alternatives as part of its analysis including loan modification, foreclosure, deed-in-lieu, negotiated payoff or sale of the defaulted loan. Frequently the Directing Certificateholder also has the ability to direct the Special Servicer's actions with respect to defaulted loans. Provided the servicing standard is maintained.

Directing Certificateholder

As mentioned earlier, the credit risks associated in most CMBS offerings in the capital markets are predicated on a tiering of credit risk and corresponding returns. In general, the most subordinate bond class is called the "Directing Certificateholder" (or the "Controlling Class"). Since all losses accruing from the non-performance of loans will be entirely absorbed by the Controlling Class, the PSA will provide the Directing Certificateholder (who often controls, directly or indirectly, the Special Servicer) the ability to make key decisions related to the modifications of loans. This is because the more senior bondholders, protected from losses by the subordinated classes of bondholders, will have less incentive to work out or otherwise take such action as is necessary to maximize returns monitoring the performance of each loan, make decisions on key asset issues and appoint and/or terminate the Special Servicer.

Trustee

The Trustee's primary role is to hold all the loan documents and distribute payments received from the Master Servicer to the bondholders. Although the Trustee is typically given broad authority with respect to certain aspects of the loan under the PSA, the Trustee typically delegates its authority to either the Special Servicer or the Master Servicer. As holder of the loans, the Trustee will be named in enforcement

actions related to the loans (such as lawsuits or non-judicial foreclosure actions) yet in most instances the Trustee is acting by and through either the Master Servicer or the Special Servicer. All Borrower interaction rarely, if ever, interacts with the Trustee.

Rating Agency(ies)

There will be as few as one and as many as four Rating Agencies involved in rating a securitization. Rating agencies establish bond ratings for each bond class at the time the securitization is closed. They also monitor the pool's performance and update ratings for investors based on performance, delinquency and potential loss events affecting the loans within the trust.

The bond ratings assigned at the time the securitization closes assume that the credit quality of the loan pool will not change significantly over time. As such, some decisions cannot be made without respect to the loans in a securitized pool without rating agency confirmation that such actions will not cause a downgrade of any of the bond class ratings. Rating Agency confirmation is frequently required with respect to actions on the largest loan in the trust, but certain items such as approval of subordinate financing may also require Rating Agency confirmation regardless of the size of the loan. The Rating Agencies will work directly with a servicer in processing these types of requests and will not interact directly with the Borrower.

Prepayment and Defeasance

A significant characteristic of CMBS bonds that are sold in the capital market is that they cannot be "called" by the issuer. This means that the purchasers of the bonds do not have to worry about the bonds being prepaid and, thus, the bondholders are assured of their yields being maintained. This feature (called "Call Protection") enables the bonds to be priced more attractively because there is a tighter spread because the yield to maturity can be calculated by the investor.

As such, in order to assure the income to the bondholders, alternate collateral must be deposited with certain enough income stream to maintain the yield on the underlying bond. The only security that

is deemed safe enough as a substitute are United States Treasury Bonds. This procedure is called "Defeasance."

It should be noted that Defeasance is not a prepayment of the loan since the note remains outstanding, but is repaid from cash flow from the government securities purchased rather than through cash flow generated by a property. The significant difference is that the lien against the underlying property is released.

In any event, defeasance is prohibited for at least the first two years following securitization due to REMIC prohibitions on substitution of collateral.

Prepayments

In the event the borrower is allowed to repay the note (in which case it is removed from the REMIC), the prepayments generally must be accompanied by a lump sum payment to compensate the bond holders for the loss of income.

Yield maintenance is determined as a present value calculation of the amount necessary to reinvest the payoff proceeds at an assumed rate of return (based on US Treasuries) at the same deemed loan maturity and the original loan maturity and maintain the same yield as if the loan had not paid off early. As such, the sum necessary to achieve the yield maintenance at any point in time depends on the level of current treasury yields relative to the loan coupon. The lower treasury rates are relative to the loan coupon, the greater yield maintenance amount. Prepayments at par are frequently allowed in many CMBS loans near the end of the loan term, commonly the last 3-6 months. More flexible prepayment terms are, however, available on floating rate CMBS than on fixed rate CMBS.

Each Borrower should carefully consider whether prepayment of defeasance is its right course of action, especially considering the potential fees involved. In certain higher interest rate environments, defeasance may provide a less expensive option for the Borrower to release the property from the trust. The out-of-pocket costs associated with defeasance, however, may make defeasance a more costly alternative for

smaller loans or in a stable to lower interest rate environment.

Miscellaneous Aspects of CMBS Loans

Lock-Box. A cash management or lock-box agreement, is an agreement that provides that all of the cash flow from the project be paid directly into an account that is controlled by the lender and in which the lender has a perfected security interest. This means that notices are sent to all of the tenants of the project requiring that rents be paid directly into this account rather than to the owner. While this procedure creates certain administrative problems from the owner's side, originators of securitized loans insist that a cash management agreement be used. Once the income from the project is in the lock-box account, funds are disbursed to various other accounts for the operation of the project. The key to a cash management agreement is that the first claim on the cash is always for principal and interest on the debt, and the lender always has a perfected security interest in the cash on hand and the cash coming into the project.

Single Purpose Entity. The singlepurpose, bankruptcy-remote structure of the borrower is designed to make it very difficult, if not impossible, for the borrower to file bankruptcy or at least to eliminate the advantages that a bankruptcy may otherwise offer to the borrowers in securitized loans. A single-purpose, bankruptcy-remote entity will have the following characteristics as a part of its organizational documents (articles and by-laws, partnership agreement, or limited liability company operating agreement):

- > The business purpose of the borrower will be limited to owning and operating the specific property that is the subject of the securitized loan.
- > The borrower may not incur any debt, whether secured or unsecured, other than the securitized loan in question (there may be an exception to this requirement for small working capital lines incurred in the ordinary course of business and other trade payables incurred in the ordinary course of business).

- > The borrower will be required to keep its funds and activities separate from those of any other entity.

- > The organizational documents must state that in making decisions (and particularly in deciding whether to file any voluntary bankruptcy case) the members or board of directors must take into account the interest of creditors as well as the interest of shareholders.

- > One of the controlling members of the borrower, such as a director of a corporate borrower or one member of a limited liability company borrower must be an independent party. This independent party may be affiliated with the originator of the securitized loan or may be a party affiliated with one of the national corporate record keeping companies such as CT Corporation. The organizational document of the borrower will then require the concurrence of this independent party before any bankruptcy proceeding can be filed.

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About the Firm:

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