Concurrent Session

Real Estate Loan Enforcement and Workouts in a Securitized World

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Educational Materials

2010

General Growth Properties: Where Loan Documents and Bankruptcy Collide

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In April, 2009, General Growth Properties, Inc. ("GGP"), a publicly traded real estate investment trust ("REIT") operating a network of approximately 200 shopping malls in 44 states, filed for Chapter 11 in the Bankruptcy Court for the Southern District of New York.[1] The case involved not only the publicly traded REIT and its first tier-subsidiary management company, but a total of 388 debtors, including over 150 special purpose entities ("SPEs") formed for the purpose of holding title to, and operating, a single project, and all of which sought joint administration.

The commencement of the bankruptcy cases was widely reported to have sent shockwaves through the capital markets. After all, weren't the project-level loan documents GGP had entered into with its lenders meant to prevent exactly that from happening?

Well, yes, they were intended to prevent exactly that. The real estate loan documents that had evolved in the commercial mortgage backed securities ("CMBS") world, and had been adopted in conventional commercial debt financing documents, revolved around several basic premises. One of those basic premises was preventing the filing of a Chapter 11 petition—the so-called bankruptcy remote aspects of CMBS financing. Another was separateness—each SPE was to stand on its own, with its own balance sheet, its own operations and its own decision making, not to be lumped into a single proceeding with 387 affiliates. Yet, there were the GGP debtor-entities, 388 strong, in jointly administered Chapter 11 proceedings.

Several of the capital market players involved in the case pushed back, first opposing use of cash collateral and later moving to dismiss the Chapter 11 cases of certain of the GGP SPEs that were parties to the loan documents containing these bankruptcy remote and separateness provisions. They were largely unsuccessful in both endeavors. Although the lenders gained some adequate protection concessions on the cash collateral front, the GGP entities were authorized to use cash collateral and the motions to dismiss were later adjudicated and denied.

It may be tempting to dismiss the General Growth case as an interesting study of the mega-case exception to situations faced in less newsworthy Chapter 11 cases. That would be a mistake. The General Growth decision on the lenders' motions to dismiss is worth reading if for no other reason than the Court's discussion of the transactions before it provides an excellent primer on the loan document provisions at issue—provisions that are virtually identical to those in documents executed in most commercial real estate

finance transactions for the five years preceding the 2008 market crash. It also chronicles the difficulties of effecting an out of court restructuring of CMBS debt. As a result, the structural obstacles to consensual resolution and the theories relating to use of cash collateral and dismissal of the cases are no less applicable to any commercial real estate case likely to be seen in any jurisdiction over the next few years than they were in the GGP case.

I. General Growth Corporate Structure and Debt

GGP is the ultimate parent of approximately 750 wholly-owned Debtor and non-Debtor subsidiaries, joint venture subsidiaries, and affiliates, 387 of which filed for bankruptcy protection, along with GGP. The GGP group of companies is primarily engaged in the ownership and operation of retail shopping centers. GGP had financed its project acquisitions and development, in part, through mortgage and mezzanine debt.

The mortgage debt consisted of conventional mortgages and CMBS financing encumbering property owned by SPEs that held title to the projects. Of over $27 billion in total debt in the GGP jointly administered cases, $18.27 billion was debt of project-level debtors secured by mortgages on the property those SPEs owned.

The bulk of the balance of the debt in the GGP cases consisted of obligations of the upper tier entities that were two or more levels above the project-level SPEs. That debt included approximately $6 billion of publicly traded bond debt, senior and junior notes. It also included obligations under interest rate swaps with a total notional value of $1.08 billion.

II. The SPE Mortgage Debt

Both the secured creditors' challenge to the use of cash collateral and the motions to dismiss focused on the title-holding SPEs, and the loan documents executed by those entities. As a result, the Court's discussion is centered on the mortgage debt incurred by those lower-tier entities.

The financial terms of most of the SPE mortgage loans included a three to seven-year term, with low amortization and a large balloon payment due upon maturity. Even those loans that contained more traditionally seen amortization provisions and longer nominal maturities provided for "anticipated repayment dates"— so called "ARDs" —in the three to seven year range, further providing for "hyper-amortization" if not satisfied on the ARD. Post-ARD hyper-amortization provisions included sharp increases in interest rates, "a requirement that cash be kept at the project-level, with excess cash flow being applied to principal, and a requirement that certain expenditures be submitted to the lender for its approval."[2] The net impact of both the short maturity loans and the hyper-amortization provisions was that, either by threat of default or imposition of draconian financial consequences, the expectation was that the mortgage debt would be refinanced.

The secured debt faced by the GGP title-holding SPEs also contained the sorts of

"separateness" provisions and "bankruptcy remote" provisions frequently seen in current real estate loan documentation and generally attributed to CMBS loan documentation. No longer limited to the CMBS documents, both the "conventional mortgage debt" of the SPEs and the CMBS loan documents of those entities contained provisions designed to keep the assets and cash flow of each SPE within the specific umbrella of that SPE and to prevent it from filing a bankruptcy petition.

A. The Separateness Provisions

As indicated by the Court, the loan deals with GGP's project-level SPEs were structured to attempt to maintain separation of the lower tier borrower from its GGP parents and affiliates. There were "restrictions in their loan documentation and operating agreements that require[d] them to maintain their separate existence and to limit their debt to the mortgages and any incidental debts, such as trade payables and costs of operation."[3] In addition to restrictions on the sorts of debt that could be incurred, there were restrictions on use of revenues. The SPE-level loan documents required that, under certain circumstances, all revenue generated by an SPE be maintained within that SPE, and not upstreamed to the SPE's parent or otherwise distributed to affiliates or other entities within the enterprise.

The theory behind these separateness provisions, as identified by the Court, is that, "the operations of the borrower [are] isolated from business affairs of the borrower's affiliates and parent so that the financing of each loan stands alone on its own merits, creditworthiness and value …."[4]

B. The Bankruptcy Remote Provisions

The SPE loan documentation also sought to prevent, or at least constrain the ability of, an SPE from filing bankruptcy. The primary bankruptcy remote provision contained in the loan documentation was a requirement that the SPE have one or more independent directors, in the case of a corporate entity, or one or more independent managers, in the case of an LLC, with a further requirement that the by-laws or operating agreement require the unanimous consent of all directors or managers to the filing of a bankruptcy.

The loan documents take some care in setting forth what will suffice as sufficiently "independent" to fill the independent manager position. The independent director cannot be (i) a stockholder, director, manager, officer, employee or attorney for the borrower; (ii) a customer or creditor of the borrower; or (iii) an affiliate or family member of any of the above. The documents except out from the exclusions an individual "provided by a nationally recognized company that provides professional independent directors, managers and trustees."[5]

Some effort is also made to set forth the role of the independent manager. The SPE's operation agreements provide, for example, that "[t]o the extent permitted by law … the Independent Managers shall consider only the interests of the [SPE], including its

respective creditors, in acting or otherwise voting on [filing or consenting to a bankruptcy proceeding]."[6] The operating agreement also acknowledges, however, that the independent manager shall have a fiduciary duty of loyalty and care similar to a director of a business corporation organized under applicable state law.

Testimony taken in connection with the motions to dismiss in the GGP case suggested that the lenders' expectation was that the independent directors would be individuals provided by Corporation Service Company ("CSC"), which would supply "these directors in the same fashion as it provides filing and other ministerial services for corporations."[7] The testimony also suggested to the Court that "some of the lenders thought the independent managers were obligated to protect their interests alone."[8]

Although not discussed in the General Growth case, another aspect of CMBS loan documentation that tends to discourage bankruptcy petitions is the "bad boy guaranty." Generally, recourse under CMBS loans is limited to the borrower, except for springing liability in the event that certain "bad boy" acts occur. The list of such acts generally includes fraud, misappropriation of assets and the filing of a bankruptcy petition by the borrower. The effect of such guaranties is to put the principals of a borrower to the choice of walking away from a project and avoiding any guaranty obligation to the lender, or filing a Chapter 11 and affording the lender full recourse to the guarantor.

III. The Structural Obstacles to Out of Court Restructurings

The General Growth decision's discussion of the structure of CMBS loans and investments, the travel and management of a CMBS portfolio, and GGP's stated efforts to work its way through that structure and management scheme prepetition illustrates many of the obstacles to out of court restructurings faced by commercial real estate borrowers with CMBS loans.

As stated in the Court's decision, "in a typical CMBS transaction, multiple mortgages are sold to a trust qualified as a real estate mortgage conduit ("REMIC") for tax purposes."[9] The REMIC then sells certificates, or bonds, to investors, who receive distributions from the principal and interest payments that the REMIC collects from the mortgages within the portfolio. The investors who purchase those certificates, or bonds, have varying rights of distribution and return, and varying degrees of control, all as defined in the transaction documents.

Primary responsibility for management of the REMIC's owned portfolio lies with a "master servicer." That master servicer can collect and distribute loan proceeds, but, other than routine waivers and consents, cannot modify the material terms of a loan or mortgage. Once a material default under a loan occurs, however, the management of the loan is shifted to a "special servicer." The special servicer has some ability to modify a loan, but generally requires some document defined consent from one or more levels of holders of the certificates to effect such a modification.

The GGP decision suggests that GGP was caught in a limbo created by the CMBS

structure. Only the special servicers could negotiate a loan modification, but the special servicers only would be appointed if there were a material, uncured default. When GGP approached master servicers in an attempt to discuss loan modifications, it was turned away—the master servicers being without authority to either agree to modifications or even transfer a loan to a special servicer because there had been no uncured default.

There is no discussion in the GGP decision regarding the second potential limbo when dealing with CMBS loans. Even after a default and the appointment of a special servicer, negotiations can be difficult due to the certificate holder consents that may be required as a condition to a special servicer agreeing to a modification.

IV. The Commencement of the GGP Chapter 11 Cases

Faced with defaults on a number of projects, at least one pending foreclosure proceeding, some rapidly approaching maturities with no realistic capability to obtain refinancing, deal structure imposed obstacles to a restructuring and a liquidity crunch brought on in part by the need to dedicate an increasing percentage of its operating revenues to deal with hyper-amortized loan obligations, GGP filed the Chapter 11 cases. It managed its way around the bankruptcy remote provisions of the SPE-level loan documents through the immediate parent entities of those SPEs terminating the services of the independent directors thought to be beholden to the lenders and replacing them with two individuals who also fit the document provided definition of independent. After a review period, votes of the reconstituted boards were taken to commence the Chapter 11 cases.

In the early days of the case, the lenders objected to GGP's proposed use of cash collateral. They argued that the requested use of cash collateral envisioned upstreaming excess cash generated by debtor SPEs with positive cash flow into the parent, and then the parent's downstreaming that same cash to cover the operating expense shortfalls of negatively cash flowing SPEs in violation of the loan documents' separateness provision. The Court did not disagree with the factual statement, just with the conclusion—holding that "the SPE structure did not require that the project-level Debtors be precluded from upstreaming their cash surplus at a time it was needed most by the Group."[10] The final order afforded the lenders certain adequate protection rights, however, including interest payments at the non-default rate, a replacement lien on the cash being upstreamed by the project-level Debtors and a second priority lien on certain properties.

Five lenders then moved to dismiss the Chapter 11 cases relating to title-holding SPE's regarding which they held or controlled the secured debt. Couched as a motion to dismiss as bad faith filings, the lenders asserted that there were several indicia of bad faith.

The moving lenders argued first that, both as a matter of substantive bankruptcy law and in accordance with the separateness provisions of the loan documents, each SPE should be tested separately. Because many of the SPE debtors were not in immediate financial distress, indeed they were meeting all of their secured and unsecured

obligations, producing positive cash flow and had no imminent maturities that they themselves had to contend with, viewed on their own, the SPEs' filings were "premature," unnecessary and in bad faith. They added to the consideration assertions that the lenders would oppose any plan that impaired them proffered by an SPE and, therefore, that SPE could not hope to confirm a plan.

The moving lenders also asserted the existence of bad faith warranting dismissal in what they characterized as the SPEs' failure to attempt to negotiate a resolution prepetition. Finally, the lenders asserted that the surreptitious removal of the independent directors that the lenders were counting on to prevent a bankruptcy filing, as well as running afoul of their understanding of the loan documents, was evidence of bad faith.

On August 11, 2009, the Court issued its decision, disagreeing with the moving lenders and denying the motions to dismiss.

V. The Court's Reasoning in Denying the Motions to Dismiss

The Court's decision centered on an examination of the bad faith filing doctrine as it had developed in the Second Circuit. Describing the concept of dismissing a Chapter 11 case for bad faith in its filing as a "judge-made doctrine," the Court stated that, "the standard in [the Second] Circuit is that a bankruptcy petition will be dismissed if both objective futility of the reorganization process and subjective bad faith in filing the petition are found."[11] No one factor is determinative of good faith and the court "'must examine the facts and circumstances of each case in light of several established guidelines or indicia, essentially conducting an on-the-spot evaluation of the Debtor's financial condition [and] motives.'"[12] The Court further stated that case law recognizes the doctrine should be used "sparingly and with great caution."[13]

A. Objective Bad Faith

In support of their contention that the project-level Debtors' Chapter 11 filings were in bad faith because premature, the movants argued that the SPEs were solvent enterprises not in default on their facilities and which did not carry debt with impending maturities. The movants also relied on case law in which courts dismissed the bankruptcy cases of debtors that were not in financial distress at the time of filing, where the prospect of liability was speculative, and where there was evidence that the filing was designed to obtain a litigation advantage.[14]

The Court distinguished the cases relied upon by the movants, noting that the prospect of any liability from pending litigation in those relied-upon cases was "wholly speculative."[15] By contrast, the Court concluded that the subject SPEs carry an enormous amount of fixed debt that is not contingent, and that each of the subject Debtors were in varying degrees of financial distress as of the petition date.[16] The Court noted that there is no Code imposed requirement of "any particular degree of financial distress as a condition precedent to a petition seeking relief," recognized the policy of encouraging debtors to file sooner rather than later and refused to establish a rule that

imminent maturity was needed to sustain a good faith bankruptcy filing.[17] The Court found that the project-level Debtors were reasonable in concluding that they would be precluded from refinancing their maturing real estate debt in the future given the uncertainty surrounding the CMBS market, citing to the Debtor's unrebutted evidence that the CMBS market, in which the Debtor's had historically financed and refinanced their properties, was "dead" as of the petition date, and it was unknown when or if the market could revive.[18]

The movants' separateness covenant-based argument—that each project-level Debtor's financial health was to be analyzed solely on a project by project basis—was also rejected. The Court disagreed with the argument that it was required to examine each project-level Debtor as an independent entity due to its SPE structure, and determined that the SPEs' boards could appropriately consider the interests of the GGP corporate group as a whole.[19] The Court recognized that, while the SPE structure was intended to insulate the financial position of each entity from its parent and affiliates, the movants were aware that "they were extending credit to a company that was part of a much larger group, and that there were benefits as well as possible detriments from this structure."[20] The Court concluded that if the ability of the GGP group to obtain refinancing became impaired, then the financial situation of the subsidiary would inevitably be impaired as well.

In addition, the Court noted that the operating agreements of the project-level Debtors required the independent managers to consider the interests of the company, including its creditors, "to the extent permitted by applicable law." Recognizing that the movants did not argue that the subject project-level Debtors were insolvent at any time, the Court determined that Delaware law required the independent managers to consider the interests of shareholders, citing *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, in which the Delaware Supreme Court held that, whatever duty an insolvent entity's directors owed to creditors notwithstanding, "[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."[21] The Court rejected any notion that an independent manager should vote "no" as to a bankruptcy filing because of the desires of secured creditors where "directors and managers owe their duties to the corporation and, ordinarily, shareholders" under Delaware law.[22] As a result, the managers' consideration of the financial situation of the GGP group as a whole was a proper exercise of their fiduciary duties, and their bankruptcy filings were found to be "unquestionably not premature," even though the SPEs' debt maturity dates were several years away.[23]

As an additional basis for its argument of objective bad faith, one of the movants suggested that the Chapter 11 cases were futile because the subject project-level Debtors could never confirm a plan over its objection.[24] The Court found that the movant's argument was premature and that the Court would not consider the futility of confirmation before a plan was proposed, noting that there is no requirement in the

Bankruptcy Code that a debtor must demonstrate a plan will be confirmable in order to file a petition.[25] The Court also noted that the parties could negotiate an agreed plan, as parties often find it in their best interests to do "despite their litigating posture," or choose to leave the debt unimpaired.[26]

B. Subjective Bad Faith

The movants also argued that the project-level Debtors acted in subjective bad faith under the circumstances because the subject Debtors failed to negotiate with the movants prior to filing for Chapter 11, and because the independent managers of the project-level Debtors were fired and replaced abruptly before the bankruptcy filings. The Court dismissed these arguments as well.

With respect to the movants' argument that failure to negotiate prepetition equated with a finding of subjective bad faith, the Court noted there is no Bankruptcy Code requirement that a borrower negotiate with its lender prepetition.[27] While the Court acknowledged that "there are often good reasons for a commercial borrower and its lender to talk before a bankruptcy case is filed," that did not mean that a Chapter 11 case should be deemed filed in bad faith if there were no prepetition negotiations.[28]

The lack of movant proffered evidence that pre-filing negotiations would have been sufficient to deal with the extent of the problem in the GGP case also factored into the Court's decision. The Court found no evidence that the movants would have even been willing to negotiate with the Debtors, focusing on the fact that there was no testimony from the movants' witnesses with final decision-making authority who said that they would have been willing to refinance or modify the terms of the respective subject Debtors' loans. Additionally, there was evidence that the Debtors "could not even get the CMBS lenders to talk to them."[29] Because only special servicers had the authority to negotiate an extension or refinancing and special servicers could only be appointed if a loan were in or near a default under the CMBS structure, master servicers simply refused to negotiate and Debtors were caught in a Catch-22.[30] The Court concluded that the project-level Debtors did not act in bad faith because they refused to postpone filing until the CMBS loans were in default or were foreclosed.

With respect to Debtors with conventional mortgage debt, not encumbered by the CMBS servicing structure, the Court found that lender internal documents in evidence stating that loans with GGP would not be refinanced belied any litigation-based position to the contrary.[31] For example, one document showed that the lender's investment analysts had concluded that "the loan-to-value ratios on several of its properties were too high and that millions of dollars of debt had to be repaid before refinancing would be considered."[32] In addition, the lender's head of real estate investments "identified its debt exposure to GGP (as a group) as a "'lessons learned opportunity'" in December 2008.[33] While these assessments did not necessarily prove what the lender would have done if the Debtors had opened negotiations, the Court determined that they did support the reasonableness of GGP's decision not to negotiate prior to filing. The Court found this to be especially true in light of the lender's stated refusal to agree to a plan impairing its

claim, noting that "[s]uch inflexibility and unwillingness to negotiate undermines [the lender's] contention that it would have been willing to work with the Debtors prepetition to refinance its loans."[34]

The movants' argument that the circumstances surrounding the firing of various independent directors and their replacement with others who ultimately voted in favor of bankruptcy was more evidence of bad faith on the part of the project-level Debtors was also addressed by the Court, and rejected. While the Court referred to these terminations as "admittedly surreptitious," it refused to hold that they were evidence of subjective bad faith.[35]

It was undisputed that the organizational documents of some of the project-level Debtors required that there be two independent managers or directors, which could be supplied by a "nationally recognized company that provides professional independent directors, managers and trustees."[36] CSC had supplied at least two "independent managers" who served on the Boards of over 150 of the project-level Debtors. The Court noted that the managers did not appear to have any expertise in the real estate business. There was evidence that the "terminations 'came as a surprise' to the independent managers because there was 'no prior indication such termination was being contemplated.'"[37] Also, the managers did not learn of their termination until after the bankruptcy filings.

The Court found that the organizational documents did not prohibit the Debtors' actions or purport to interfere with the rights of shareholders to appoint independent directors to the board of the project-level Debtors.[38] Additionally, the Court recognized that "[g]iven the significance, complexity, and time-consuming nature of assessing potential bankruptcy filings involving numerous entities, the project entities' stockholders and members desired independent managers with known experience in restructuring environments and complex business decisions, who understood the capital markets, who could commit significant time to learning about the projects, and who would bring critical, independent thinking to the restructuring challenges these project entities were facing."[39] The Court found that the newly appointed independent managers were "seasoned individuals" who "satisfied the requirements of that position."[40]

The actions of those newly appointed independent managers of voting to authorize the Chapter 11 case filings was, according to the Court, consistent with their fiduciary duties to act in the interests of the corporation and its shareholders.[41] The Court reiterated that, despite the implicit, misguided assumption of the movants that their rights were materially impaired by the Debtors' Chapter 11 filings, the independent managers did not have a duty to keep any of the Debtors out of bankruptcy, but, in fact, "[a]s managers of solvent companies charged to act in the same fashion as directors of a Delaware corporation they had a *prima facie* fiduciary duty to act in the interests of 'the corporation and its shareholders.'"[42] The Court was satisfied that the Debtors demonstrated that the filings were designed to preserve value for all constituents, including the movants. Furthermore, the Court concluded that other than having their access to their collateral postponed by the filing, a secured creditor's "panoply of rights,

including adequate protection and the right to post-petition interest and fees if they are oversecured" remained intact.[43]

VI. Conclusion

Although the moving lenders fashioned their motion as seeking dismissal of the GGP SPEs' petitions as bad faith filings, and the Court addressed the issues as fashioned, the undercurrent of the motions was one of seeking enforcement of the loan document provisions relating to separateness and bankruptcy remoteness as understood by the lenders, and the undercurrent of the Court's decision was its view that those loan document provisions were just that—loan document provisions—not alterations of Bankruptcy Code provisions regarding entitlement to file a voluntary petition or pursue a Chapter 11 case. While the Court acknowledged that the movants have been inconvenienced by the bankruptcy filings given the partial interruption of the cash flows and the appointment of special servicers for the CMBS obligations, the Court concluded that "inconvenience to a secured creditor is not a reason to dismiss a Chapter 11 case."[35] The Court emphasized that "the fundamental protections the movants negotiated and that the SPE structure represents are still in place," namely the protection against substantive consolidation, noting that nothing in the decision implied the assets and liabilities of the subject Debtors could be properly substantively consolidated with those of other GGP entities.[36]

As commentators have stated, in the end, the General Growth decision on the lenders' motions to dismiss stands for two major propositions as it relates to commercial real estate loan documents: bankruptcy remote is not bankruptcy proof, and the financial condition of the enterprise is at least equally as appropriate a consideration as is the financial health of any single member of that enterprise in reaching a determination on filing a Chapter 11 case.

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[1] *In re General Growth Properties, Inc.*, Case No. 09-11977 (ALG).
[2] *In re General Growth Properties, Inc.*, 409 B.R. 43, 50 (Bankr. S.D.N.Y. 2009).
[3] *Id*. at 49.
[4] *Id*.
[5] *Id*. at 63, n33.
[6] *Id*. at 63.
[7] *Id*. at 67, n38.
[8] *Id*. at 67.

[9] *Id*. at 51.
[10] *Id*. at 55.
[11] *Id*. at 56 (*quoting In re Kingston Square Assocs*., 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1996)(internal quotations omitted).
[12] *See id*. (internal quotations omitted).
[13] *Id*. at 56.
[14] *See, e.g., In re SGL Carbon Corp.*, 200 F.3d 154 (3d Cir. 1999); *In re Schur Mgmt. Co. Ltd.*, 323 B.R. 123 (Bankr. S.D.N.Y. 2005).
[15] *General Growth*, 409 B.R. at 57.
[16] *See id*.
[17] *Id*. at 61 (*quoting U.S. v. Huebner,* 48 F.3d 376, 379 (9th Cir. 1994)).
[18] *See id*. at 60.
[19] *See id*. at 61-62.
[20] *Id*. at 61.
[21] *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).
[22] *Id*. at 64.
[23] *See id*.
[24] *See id*. at 65.
[25] *See id*.
[26] *See id*.
[27] *See id*. at 66.
[28] *See id*.
[29] *Id*.
[30] *See id*.
[31] *See id*. at 67.
[32] *Id*.
[33] *Id*.
[34] *Id*. at 67, n37.
[35] *Id*. at 68.
[36] *See id*. at 68.
[37] *Id*. at 67-68.
[38] *See id*. at 68.
[39] *Id*. at 68.
[40] *Id*.
[41] *Id*.
[42] *Id*. at 68 (*quoting Gheewalla*, 930 A.2d at 101).
[43] *Id*. at 69.

CMBS Facts, Figures and History

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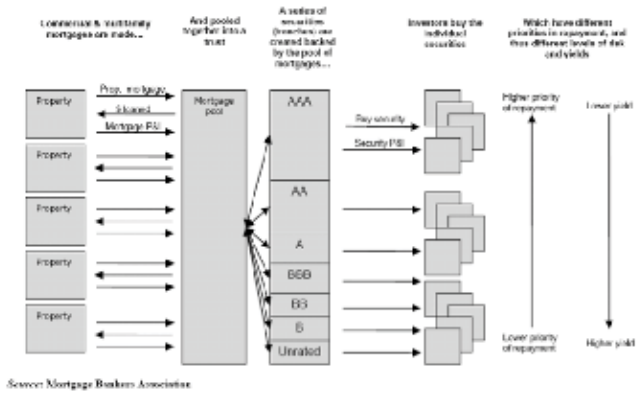
Commercial Mortgage Back Securities

- Commercial Mortgage Backed Securities (CMBS) are bonds that are secured by commercial real estate loans.
- CMBS are not standardized which makes it difficult to rate and value. Typically a pool of commercial loans consisting of many single mortgage loans of varying size, property type and location are pooled and transferred to a trust. The trust issues a series of bonds that may vary in yield, duration and payment priority. Nationally recognized rating agencies then assign credit ratings to the various bond classes ranging from investment grade (AAA/Aaa through BBB-/Baa3) to below investment grade (BB+/Ba1 through B-/B3) and an unrated class which is subordinate to the lowest rated bond class.
- Investors may then choose which bonds to purchase based on the level of credit risk/yield/ duration they seek. Each month the interested received from all the pooled loans is paid to investors starting with those holding the highest rated bonds, until all accrued interest on the bonds is paid. At that point, interest is paid to holders of the next highest rated bonds and so on. The same process unfolds with principal payments as payments are received. This sequential payment structure is generally referred to as the "WATERFALL."

Source: "Borrower Guide to CMBS" written by The Commercial Mortgage Securities Association (CMSA – now the CREFC) and the Mortgage Bankers Association (MBA)

2

CMBS Distribution Process



Source: Mortgage Bankers Association

- CMBS allows for commercial lenders to deleverage their portfolio by utilizing the public markets.
- In the distribution process many entities play critical roles including servers, investment bankers, rating agencies and investors.
- This sequential payment structure is unique in this security pool. Securities with lower ratings are paid last

3

CMBS Servicers

- **Master Servicer -** The Master Servicer services the loans in the pool through maturity unless the Borrower defaults. The Master Servicer manages the flow of payments and information and is responsible for the ongoing interaction with the performing Borrower.
- **Primary Servicer** (or Sub-Servicer) - In some cases the Borrower may deal with a Primary Servicer that may also be the loan originator or Mortgage Banker who sourced the loan. The Primary Servicer maintains the direct Borrower contact, and the Master Servicer may sub-contract certain loan administration duties to the Primary or Sub-Servicer.
- **Special Servicer -** Upon the occurrence of certain specified events, primarily a default, the administration of the loan is transferred to the Special Servicer. Besides handling defaulted loans, the Special Servicer also has approval authority over material servicing actions, such as loan assumptions. If there is a shortfall in contractual loan payments from the Borrowers to the special servicer or if loan collateral is liquidated and does not generate sufficient proceeds to meet payments on all bond classes, the special servicer will pay the senior class first in order of priority. The lowest subordinated class will incur the first losses with further losses impacting more senior classes in reverse order of priority.

4

Other CMBS Parties

- **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 Pooling and Servicing Agreement, the Trustee typically delegates its authority to either the Special Servicer or the Master Servicer.
- **Rating Agency** - 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.
- **Investors -** Investors are primarily commercial banks and insurance companies. Investors choose which CMBS bonds to purchase based on the level of credit risk/yield/duration that they seek. Each month the interest received from all of the pooled loans is paid to the investors, starting with those investors holding the highest rated bonds, until all accrued interest on those bonds is paid. Then interest is paid to the holders of the next highest rated bonds and so on. The same thing occurs with principal as payments are received.
- **Directing Certificateholder / Controlling Class / B-Piece Buyer** - The most subordinate bond class outstanding at any given point is considered to be the Directing Certificateholder, also referred to as the Controlling Class. The investor in the most subordinate bond classes is commonly referred to as the "B-piece Buyer." B-piece Buyers generally purchase the B-rated and BB/Ba-rated bond classes along with the unrated class.

5

History of CMBS – The Design Phase

- The commercial real estate capital and secondary market can trace its origins to October 6, 1979 - Bloody Sunday – when in an effort to combat inflation, the Federal Reserve Board raised the discount rate 1%, sending shock waves through the investment markets. During the next two years, interest rates reached all time highs and capital flows to commercial and residential mortgages nearly stopped. Portfolio lenders struggled with liquidity.
- The residential mortgage market switched from being a portfolio asset to a capital market asset which helped develop the secondary market in commercial mortgages. Changes in regulation, such as the 1981 Economic Recovery Tax Act incentives, and declining interest and inflation rates helped set the stage for the first securitized commercial transactions.
- The commercial mortgage market began a slow recovery in the spring of 1982, and life insurance companies reentered the market nationwide. The life insurance companies needed to develop liquidity. In 1983, interest rates fell and life insurance companies experienced strong capital gains from their bond portfolios, which encouraged many to begin active bond trading for the first time. After their bond portfolios were repositioned, commercial mortgages came under review. Thus, early bond gains spurred the insurers to also trade several private commercial whole loans between life insurance companies. These initial transactions identified many impediments and obstacles to the secondary marketing and securitization of commercial mortgages. As the 1980s progressed, the deregulated savings and loan institutions (S&Ls) and banks plunged into commercial lending in an attempt to offset their recent problems with low interest rate residential portfolios in a high interest rate environment.

6

Source: CRE Finance Council

History of CMBS - The Design Phase

- In December 1983, the first securitization in the commercial real estate capital market occurred when Fidelity Mutual Life Insurance sold $60 million of 100% beneficial ownership participation in a pool of commercial mortgages to three life insurance companies through Salomon Brothers Realty Corporation. Fidelity retained responsibility for loan servicing and agreed to advance principal and interest payments and to repurchase or substitute new mortgages for any mortgage in the pool that defaulted. This transaction was rated AAA by the rating agencies, and three other life insurance companies went on to use the same format in 1984. But by 1984, the credit crunch was mostly over and life insurance companies, banks, and S&Ls were under pressure to lend. The portfolio commercial mortgage debt market was driven to all time highs and displaced CMBS transactions until the early 1990s.
- In the fall of 1984, Standard & Poor's presented the first commercial real estate risk-rating format with actuarial and property-specific guidelines for CMBS.
- The first multi-property, single-borrower CMBS transaction was issued in late 1984 when a Mel Simon shopping centers portfolio was securitized. In 1985, Lincoln National Life issued a pass-through CMBS, and Midwest Federal of Minneapolis issued the first thrift commercial mortgage pool securitization. In 1985, estimated issuance of pooled commercial mortgage securities spiked to $3.7 billion.

7

Source: CRE Finance Council

History of CMBS - The Design Phase

- By 1989, excessive portfolio lending, overabundance of capital, and poor market discipline created an overbuilt commercial market. Congress passed the Financial Institutes Reform, Recovery, and Enforcement Act (FIRREA), which created the Resolution Trust Corporation (RTC) to handle the savings and loan crisis. FIRREA also included new regulations, making it more onerous for savings institutions to hold commercial real estate loans.
- In 1990, another credit crunch cut off traditional commercial real estate capital, resulting in portfolio lenders suffering their worst losses since the Great Depression. Thrifts left the business, and the RTC had to find a way to liquefy a huge number of failed thrift assets before its charter expired in 1995. Commercial mortgages were out of favor, so the RTC found that they could not sell whole-loan assets effectively in direct investor-to-investor transactions so they turned to the capital markets. By 1989, excessive portfolio lending, overabundance of capital, and poor market discipline created an overbuilt commercial market. Congress passed the Financial Institutes Reform, Recovery, and Enforcement Act (FIRREA), which created the Resolution Trust Corporation (RTC) to handle the savings and loan crisis. FIRREA also included new regulations, making it more onerous for savings institutions to hold commercial real estate loans.

8

Source: CRE Finance Council

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9

Source: CRE Finance Council

History of CMBS – The Engineering Phase

- The RTC faced many obstacles in the liquidation and securitization of commercial mortgages due to a lack of standardization and infrastructure that needed to be established in order to create a receptive investor base.
- By 1991, the RTC was fully staffed and hired investment bankers to assist in the liquidation of the commercial mortgages. The investment banking group approached Equitable Real Estate to service the first RTC CMBS. After Equitable agreed, other entrepreneurial organizations, CPA's and rating agencies responded to the new opportunity presented. Serious research into the components of commercial real estate lending and servicing began. Separate job functions were identified, standards developed, and costs segregated. For the first time, institutional research was applied to commercial real estate investments.
- The foundation for a capital market was permanently established. RTC adopted the master servicer-special servicer concept. Master servicing (the day-to-day collection of mortgage payment and administration), primary servicing, and special servicing (the work out of troubled loans) became recognized occupations rather than adjunct activities to commercial real estate mortgage origination and production.
- The RTC liquidation converted a private financing business to a public markets product. By the end of 1995, the RTC had securitized $16.89 billion of performing and $977.5 million of nonperforming commercial mortgages. While only 3% of over $1 trillion in commercial mortgages outstanding in the U.S. were securitized in 1992, by the end of 1995, 6.5% were securitized and investors developed an appetite for CMBS.

10

Source: CRE Finance Council

History of CMBS – The Manufacturing Phase

- Non-RTC issuance really began to build in the mid-to-late 1990s and can be classified into two broad categories:
  - securitization of existing loan portfolios
  - securitization of new loans originated for the purpose of contributing to the underlying collateral pools.
- Previously, portfolio securitizations consisted of both performing and nonperforming loans and provided an exit strategy, not just for the RTC, but also for some insurance companies and pension funds that used securitization to monetize their portfolios. By the late 1990s, however, most CMBS deals consisted of newly originated loans, as firms originated loans to feed investors' developing demand for CMBS.
- The manufacturing phase brought a more systematic approach to loan originations. The underwriting process incorporated more standardized documents, bankruptcy-remote special purpose entities (SPEs) as owner/borrower organizations, in-depth environmental due diligence, and third-party evaluation/inspection. Because of the legal fiduciary responsibilities attached to the rated public capital markets, the manufacturing phase broadened the number of professionals involved in the loan origination, servicing and asset management processes.

11

Source: CRE Finance Council

History of CMBS – The Manufacturing Phase

- The ability of B-piece buyers to evaluate, price and invest in the below investment-grade securities was a major event in expanding the marketplace. Third parties began to invest in the first-loss risk class providing institutions with the ability to originate and securitize loans without having to burden their own balance sheet with concentrated risk classes. The assumption of first loss justified third-party reporting services and dealer secondary-trading, which have since increased liquidity and enabled relative value comparisons with other debt products in the capital markets.

12

Source: CRE Finance Council

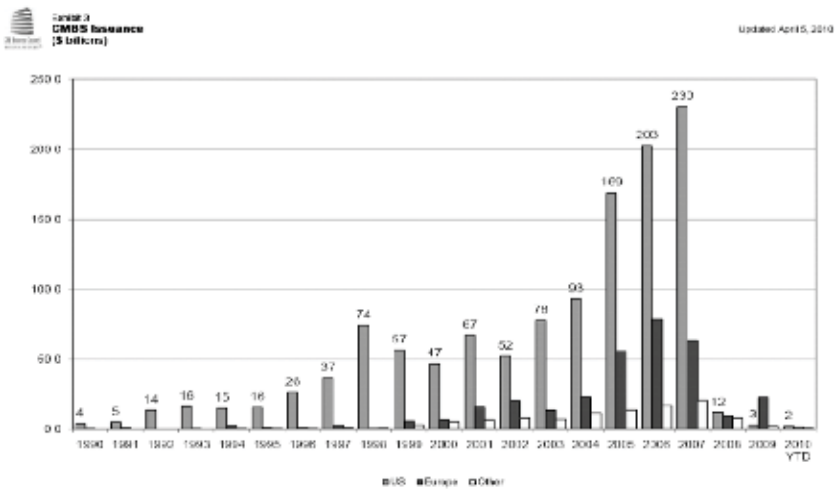
History of CMBS – The Recycling Phase

- The recycling phase began in 1997 when portfolio lenders faced intense competition from the capital markets and began to differentiate their offerings with flexible loan terms such as maturities, restructures, ownership types, secondary debt, and other options that the capital markets were not yet offering.
- Traditional portfolio lenders began to investigate the options that the capital markets might hold for them. Several decided to adopt the capital market techniques for part or all of their commercial mortgage lending.
- Lenders are now capable of "recycling" their commercial mortgages into the capital markets when CMBS loan pricing and terms are competitive with the portfolio lender's offerings.

13

Source: CRE Finance Council

CMBS Issuance



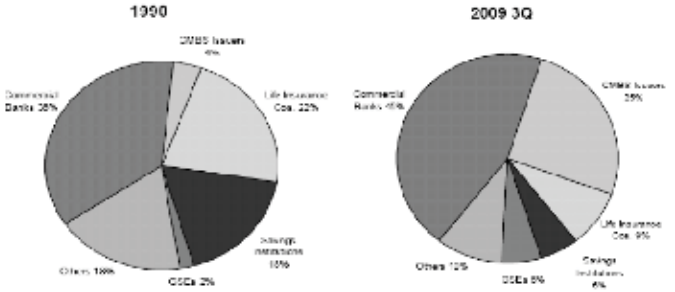
The US CMBS market peaked in 2007 and then came to a halt in 2008 and 2009.

14

Source: CRE Finance Council

Holders of Commercial and Multi-family Loans

$905 billion of the $3.4 trillion U.S. commercial and multifamily mortgage loans outstanding are held as securities, a significant increase since 1990

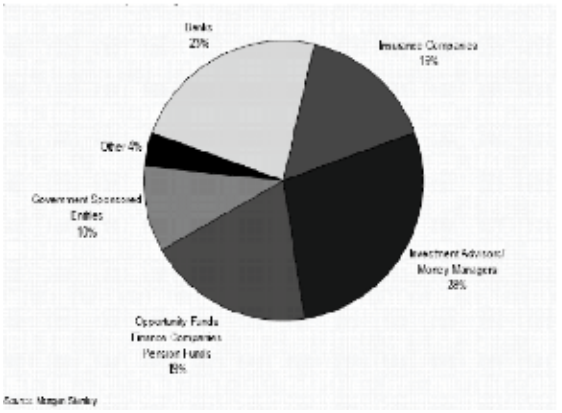


Source: Federal Reserve, Flow of Funds, Updated March 30, 2009.

I think the date is wrong above, data is as of Q3 which makes it impossible.

15

CMBS Investors



Source: Morgan Stanley

Trying to find updated info.

As of March 31, 2008

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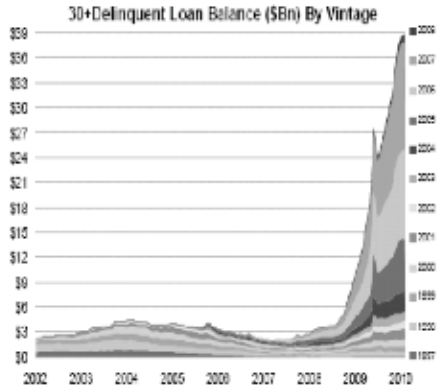
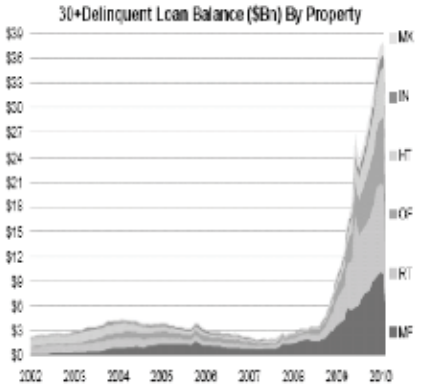
CMBS Delinquency

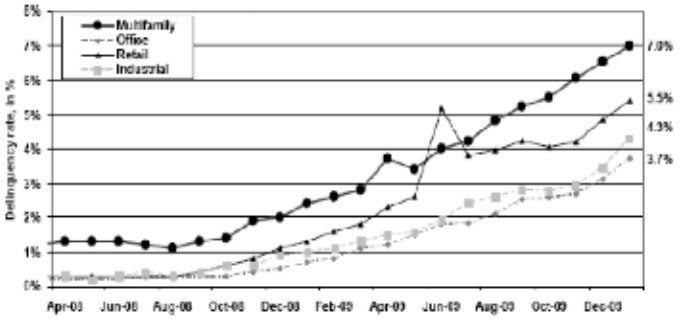




- CMBS originated in 2007 represent the largest number of delinquencies
- Multi-family, Retail, and Office represent the largest segments of CMBS delinquencies

17

Delinquency by Property Type

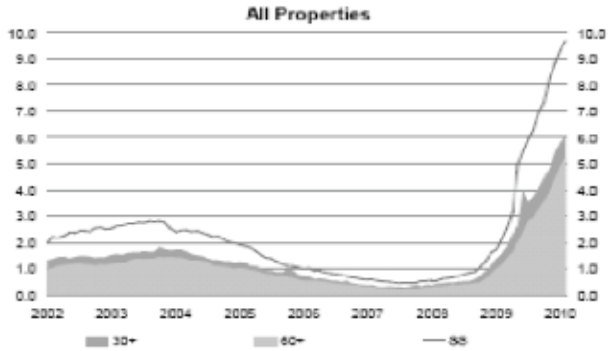


Source: Realpoint, Macquarie Capital (USA), February 2010

18

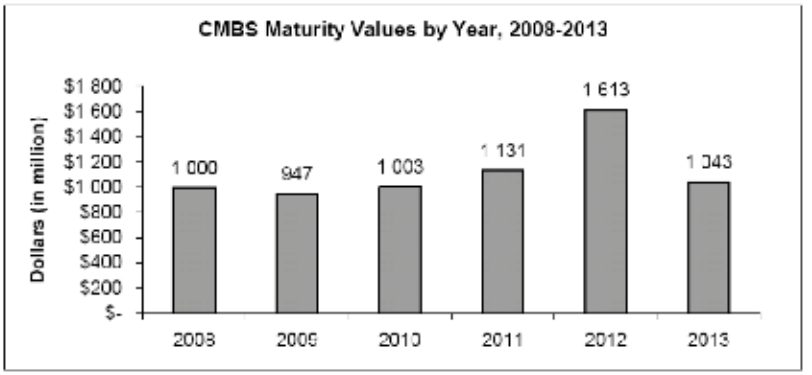
5/20/10

Delinquency and Special Servicing Rates



19

CMBS Maturities



Source: REALpac

This data is dated from 2008, I asked Gabe to look for an update.

20

Bookrunners

	2009 Issuance ($Mil.)	No. of Deals	Market Share (%)	2008 Issuance ($Mil.)	No. of Deals	Market Share (%)	'08 '09 % Chg.
1 Bank of America	$2,570.6	8	29.5	$1,313.7	5	35.8	95.7
2 Deutsche Bank	1,482.2	2	17.0	0.0	0	0.0	
3 Jefferies & Co.	1,273.3	5	14.6	0.0	0	0.0	
4 J.P. Morgan	1,126.3	5	12.9	834.2	4	22.7	35.0
5 RBS	955.1	4	11.0	1,525.1	6	41.5	-37.4
6 Credit Suisse	799.9	2	9.2	0.0	0	0.0	
7 Goldman Sachs	497.3	1	5.7	0.0	0	0.0	
TOTAL	8,704.7	27	100.0	3,673.0	15	100.0	137.0

Source: Commercial Mortgage Alert
As of 12/31/09

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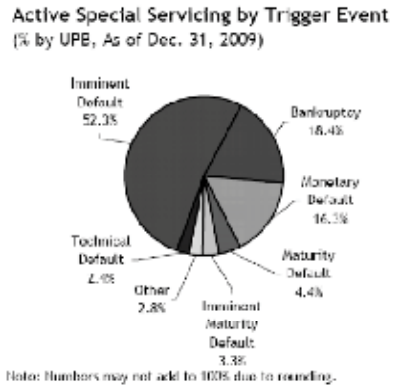
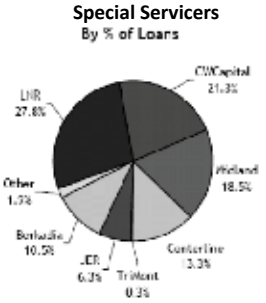
Special Servicing





Source: Fitch Ratings; CMBS YE 2009 Servicing Update

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