Distress signals

Commercial mortgage-backed securitisation arrangements may be subject to litigation as transactions come up for refinancing in a depressed market. *Ian McDonald*, *Gina Hartnett* and *Kristy Zander* explain

A number of high-profile commercial mortgage-backed securitisation (CMBS) transactions are involved in restructuring negotiations. The distress in Europe's structured real estate sector has given rise to a great deal of publicity and concern over what will happen when around £70bn of mortgage loans in CMBS structures become due for refinancing in the next few years. If these transactions cannot be refinanced, or restructured consensually, investors will seek alternative methods of extracting value from the structures. Some will perceive litigation to be one potential avenue.

In assessing the options, the key considerations will be:

- the role of the special servicer and the extent of its powers to take action to work out the transactions;
- the limitations imposed by the CMBS structure on the ability to utilise options for maximising value; and
- the potential for the situation to become contentious and the routes available if it does.

Role of the special servicer

A commercial mortgage-backed loan in a CMBS will become, on the "loan" side of the structure, "specially serviced" on a loan event of default. The special servicer has broad powers that enable it to maximise value for the various levels of lender. It will not usually owe a duty to other creditors, such as swap counterparties and other service providers, but those creditors mostly rank higher in payment waterfalls than do lenders. The powers were originally designed to deal with issues including the extraction of rent, but they are now being applied in the order context and to more complex scenarios.

Complications arise, in particular, when the special servicer is dealing with stakeholders on the "note" side of the CMBS structure, as opposed to the asset side; default is not likely to arise under CMBS notes (the securities issued by the issuer) until a note payment has been missed, even if there is significant distress at the asset level.

The powers of the special servicer are governed by the "servicing standard", the application of which is as yet untested in the English courts. It is part of the peculiar nature of its role that the special servicer must consult with the most junior lender with "skin in the game" (namely some remaining value in their stake), which becomes the "controlling class" of creditors in a CMBS. An irreconcilable conflict could arise if, for example, the controlling class wants to hold and the senior lender wants to sell. The special servicer will be obliged to consult with the controlling class, which has veto rights in respect of certain actions. There is usually no voting mechanism for the constituents of the controlling class; thus, the special servicer may need the consent of all the noteholders in that class (or rely on deemed consent provisions) to proceed.

Options for extracting value

Enforcement options with regard to a distressed CMBS are limited and will depend on the documentation.

The usual routes involve negotiations with interested parties, often with the special servicer (in consultation with the controlling class) taking the lead. Depending on the proposed actions, it may also be necessary to obtain the approval of rating agencies or the consent of the security trustee. In general, the latter will not be able or want to exercise wide discretion and will therefore have to rely on the mechanisms set out in the note documentation to seek noteholder consent.

A sale of the underlying properties is an obvious enforcement route, but one that may be a last resort for special servicers that are keen to avoid a fire sale of assets in the current market. The controlling class will usually have a veto right over such a sale and, in any event, the security trustee will ultimately need to facilitate the sale by the release of security.

Refinancing is another obvious option, but this is likely to prove challenging in the current market.

Debt buy-backs have proved successful in some cases. However, this requires a cash injection from the structure (which may not be available), provision in the documents (which may not exist) and the consent of the key players (which may not be forthcoming).

It is also possible to amend the terms of the documentation or to waive or cure defaults. However, it will be necessary to obtain appropriate levels of consent if these are to be implemented.

Debt-for-equity swaps may be available in certain circumstances, particularly in operating company CMBS structures; there have been cases where these have been successful. However, obtaining the consent of all relevant parties was crucial.

In essence, there is no definitive solution and, depending on the documentation, the tension between the controlling class and senior lenders may result in complex and protracted negotiations.

Potential litigation

Litigation, or the threat of it, can delay or restrict the special servicer's ability to implement a work-out plan and thereby realise value for investors. Sometimes, however, the court's involvement may be needed before the deal can move forward.

Issues surrounding the interpretation of CMBS contractual documents are likely to be in the vanguard of disputes going to the English courts. A string of such cases (regarding payment waterfalls) came before the courts when structured investment vehicles, such as Cheyne and Sigma Finance, went into receivership. When examined closely by parties with competing economic interests, it may emerge that particular provisions (for example, those dealing with cash flows) are ambiguous or conflict with provisions in other documents or at other levels in the structure. The special servicers of some high-profile distressed CMBS transactions are dealing with these types of issues, which may be determined in court if they cannot be resolved consensually.

The work-out plan, or the process by which it was designed, may also be an area of potential litigation. This is where issues of control come to the fore. A real conflict may arise between what is in the best interests of senior noteholders (a sale strategy to recover the debt, for instance) and junior noteholders (a hold strategy to preserve value until prices rise). In most cases, the special servicer will owe obligations to all investors. Unless middle ground can be found or sufficient value can be recovered for all investors, some groups are likely to be upset by the plan. This is complicated by the fact that the special servicer's duty to consult will often be limited to the controlling class of creditors.

Each of the key players will be acting in the knowledge that any creditor that has made little or no recovery on its investment

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will be scrutinising the steps taken (usually with legal advice) and may seek to recover its loss from another party. This type of "liability litigation" will usually have a longer lead time, as investors wait to see if they can recover value more directly before turning to litigation. For noteholders, none of the potential causes of action is straightforward.

Issuers are the most obvious defendants to a noteholder's liability claim, being the party with a direct relationship with the noteholders. However, if the latter are at the point of litigation, they are likely to have exhausted all the avenues of recovery against the assets of the issuer. There may be an advantage in pursuing the issuer if doing so could provide a route for joining other defendants with whom it has a direct contractual relationship, where the noteholders do not.

Special servicers may find themselves in the firing line if their actions in devising and implementing a work-out plan (usually with legal advice) are later criticised by noteholders. One contentious issue is likely to be whether the court imposes a standard of care on the special servicer greater than the contractually agreed servicing standard.

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The biggest litigation risk for originating banks is in the area of disclosure. They will have given extensive representations and warranties to the issuer to enable it to give comprehensive disclosure in the prospectus. In some cases, the originating bank will take direct responsibility for parts of the prospectus and may have a direct liability to noteholders in the event that these are wrong.

Security/note trustees are obliged to consider the interests of noteholders, so the latter will often turn to them if things go awry. Until a default, such as non-payment, has occurred under the notes, there is little that the security/note trustee can or should be doing and it will be difficult to criticise its inaction.

Servicers, asset managers and cash managers will be liable only if their action or inaction in the original CMBS transaction is one of the causes of any difficulty.

Sword or shield?

Investors and advisers have shown a growing interest in distressed CMBS deals, which is likely to increase in 2010 as more deals mature and issues arising from distressed deals receive greater publicity.

Existing participants are likely to regard the involvement of the court as a shield, to maintain or strengthen their position. New participants, however, may come to distressed CMBS deals seeking to use litigation as a sword, looking for opportunities to maximise value in deals that are in deep distress. Key players will need to have both groups in mind when making decisions that might result in litigation; and the dynamic of the structured commercial real estate market is likely to change significantly as a result.

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