

# Client Alert

August 2015

## CMBS Loans: Borrower (and Bondholder) Beware

As discussed in our prior [Client Alert](#), the CMBS loan structure is rife with complexity and potential for abuse. Generally speaking, upon default or imminent default, the Controlling Class of bondholders (or the Directing Certificate Holder), can appoint a Special Servicer to administer the defaulted loan. While the Special Servicer is held to a “servicing standard” that requires it to act with a requisite level of care so that the value of the CMBS loan is maximized for the benefit of all of the bondholders of the Trust (not just the Controlling Class which appoints it), many Borrowers (and bondholders) have experienced damages as a result of the inherent conflicts of interest in CMBS structures. Simply said, when conflicts of interest enter into the loan workout or restructuring calculus, optimal loan restructuring results are at risk, and both Borrowers (who could lose their properties) and bondholders (who could suffer losses on bonds) are well advised to be on heightened alert.

### Are Conflicts Real or Imagined?

It is important to note that conflicts of interest in CMBS structures exist. These conflicts have been recognized not only by aggrieved Borrowers but also by bondholders. In fact, conflicts have become of such a concern, that the rating agencies have placed the CMBS world on notice. See Standard & Poor’s Comments on Potential Conflicts of Interest Within Commercial Special Servicing Market (March 9, 2012) (the “S&P Comments”).

While conflicts can arise in many situations, Borrowers are often prejudiced in their workout attempts when a Special Servicer is guided not by what is best for the CMBS Trust, but what is best for the Special Servicer.

### Who Appoints the Special Servicer?

The Special Servicer is generally appointed by the Controlling Class of bondholders and in some cases one bondholder, often called the Directing Certificate Holder. This party, therefore wields considerable power over the servicer, including the right to “hire and fire” the servicer. It should come as no surprise, therefore, that the Special Servicer, while duty bound

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to maximize the value of a loan for all bondholders, has a special incentive to favor the Controlling Class holder.

#### Special Servicer Affiliated with the Controlling Class Holder?

A similar concern arises when the Special Servicer is either affiliated or has a similar close relationship with the Controlling Class or its Directing Certificate Holder. It is not uncommon for an affiliate or closely connected party to purchase bonds so as to control the appointment of a Special Servicer. In the event a Borrower faces this situation, heightened alert for conflicts is warranted. The S&P Comments made clear that given the increase in specially serviced loans, it is “monitoring potential conflicts of interest that may arise between the special servicer, its affiliates, and/or its parent, especially when a servicer has changed ownership.”

#### Special Servicers Have the Right to Buy Assets or Defaulted Loans

Borrowers must also be aware that, while they are negotiating with the Special Servicer, many CMBS Pooling and Service Agreements (“PSA”), contain a so-called “fair value purchase option”, which gives the servicer (or the Controlling Class) the right, or option, to purchase a specially serviced loan. This option is often assignable depending on the terms of the PSA.

One can see a potential conflict arising whereby the Special Servicer may be disincentivized to take a Borrower’s workout offer, even if it’s for fair or even above market value, if the Special Servicer or the Controlling Class holder can acquire the loan at a lower price.

#### Valuation, Appraisals and the Fair Value Purchase Option

The beginning of any workout requires an understanding of value. For both Borrowers and lenders, valuation of the property should, in most circumstances, drive decision making. The Special Servicer should, in most cases, be seeking to maximize the recovery on a defaulted loan for the CMBS Trust.

Generally speaking, Special Servicers are required to order an appraisal within 60-90 days of their appointment. This appraisal, among other factors, aids in determining the fair market value of the property.

There are many cases where Borrowers suspect that their loan (or property after a foreclosure) was sold to a party alleged to be affiliated with the Special Servicer for under market value or terms. In fact, we have seen cases where a Borrower has offered MORE (sometimes significantly more) for its loan than the Special Servicer obtained when selling the loan

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to the Controlling Class holder (who again, often has “hire and fire” power over the Special Servicer).

In this case, not only is the Borrower harmed (as it was willing to pay more for its loan resolution than the Special Servicer may have obtained) but also are the bondholders (who could suffer losses in the CMBS Trust). Recall, the Special Servicer is required by the Servicing Standard to maximize the value of a loan for ALL bondholders, not just the Directing Certificate Holder or the Controlling Class (which may be an affiliate or otherwise unduly influential over the Special Servicer). The S&P Comments state that “If a special servicer exercises the fair market value purchase option and sells a defaulted asset to an affiliate or parent, the fair market value calculation may be questioned even if the value has been independently verified.”

### Conclusion

Parties who are entering negotiations with, or reviewing decisions made by, Special Servicers should be aware of potential conflicts of interest and should ensure their rights are protected. Understanding the motivations and potential conflicts of interest during workout or restructuring negotiations may aid in stopping a problem before it is too late or, may provide parties with valid defenses to alleged defaults.

For more information regarding CMBS loan restructurings, please contact the Olshan attorney with whom you regularly work or Adam Friedman to discuss any of these matters.

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