

# WHAT'S YOUR EXIT STRATEGY?

*Property owners with mortgage loans scheduled to mature in 2009 should immediately evaluate exit strategies, expert says.*

By E. David Coligado

In light of today's financial situation, typical exit strategies for property owners are not available. Sales have slowed down, the availability of new debt is limited by tighter loan restrictions, and the lack of previously available exit strategies is particularly troublesome for property owners of income-producing projects who are otherwise in full compliance under existing loans with 2009 maturity dates. For many, modification of existing loans may be the best alternative. Property owners must carefully evaluate their particular situation to understand whether lenders will be willing to modify the terms of their loans.

## WHO IS THE LENDER?

The key consideration in understanding modification alternatives is the type of lender involved. With portfolio lenders such as banks or insurance companies, the lender who originated the loan continues to hold the loan and controls the decision on loan modification. In these situations, the property owner has continued its relationship with the lender who originated the loan, and the lender is oftentimes as aware of the situation as the property owner. Provided that the loan is not otherwise in default, these type of lenders are generally willing to work with their "customer" to maintain the relationship. Loan modification alternatives include extension of the term, funding additional proceeds, adding new collateral as security for the loan, and adjusting the payment schedule. With these type of lenders (sometimes referred to as "relationship lenders"), the relationship the borrower has with the lender will influence the flexibility available in modifying the terms of the loan, and factors outside the mortgage loan can impact the relationship lender's decision. For example, the

lender may hold other loans or other accounts with the property owner, and those other relationships may impact the decision to modify the loan.

Many commercial loans are not with "relationship lenders", but are securitized loans. Securitized mortgages are placed in real estate trusts, and, generally, there is no relationship between the original loan originator and the current holder of the loan (a "securitization trust"). The borrower's relationship with the "lender" is through the loan servicer, whom services mortgage loans on behalf of the various certificate holders of interests in the securitization trust (generally, large financial institutions). Commercial Mortgage Alert reports that over \$18 billion of securitized mortgages are scheduled to mature in 2009, and property owners must anticipate the limitations that servicers have with modifying mortgage loans within the securitization trust.

## MODIFICATION LIMITATIONS

The two key limitations that loan servicers have in modifying a loan are the limitations created by the tax treatment of the securitization trust and the limitations created by the pooling and servicing agreement.

The securitization trust is a Real Estate Mortgage Investment Conduit, or REMIC, which is a special purpose vehicle established for favorable tax treatment of the trust. In order to get the favorable tax treatment as a REMIC, all REMIC restrictions established by the Internal Revenue Code are strictly enforced by the loan servicer. From the perspective of a property owner wanting to modify loan terms, the most important restrictions of a REMIC are that no additional loan funds may be advanced by the trust, and no additional collateral may be

added to the trust. Thus, the modification of a securitized loan cannot involve the advancement of additional funds by the trust, nor may additional collateral be added as security for the loan.

Loan servicers handle mortgage loans on behalf of the certificate holders of the trust under a pooling and servicing agreement (the "PSA"). The PSA establishes the servicing standard that must be maintained by the loan servicers on behalf of the certificate holders. The "Master Servicer" handles the regular payments of the loans and the "Special Servicer" handles defaulted loans and loans anticipated to be in default. Loan modifications are negotiated with the Special Servicer.

The motivating factors behind the Special Servicer's decision to modify a loan include the servicing standard established by the PSA and the Special Servicer's fees and compensation under the PSA. In handling a loan, the loan servicer must:

- Follow the terms of the PSA.
- Follow the terms of the mortgage loan documents.
- Follow the higher of the standard it would use if it owned the loan or for a third party.
- Evaluate the loan without regard to the loan servicer's relationship to the borrower, ownership of certificates in the trust, ownership of property outside of the trust, or obligation to make advances to the trust.
- Obtain the maximum repayment value on a defaulted loan based on a "net present value" analysis of the loan.

Thus, the servicing standard created by the PSA limits the discretion the Special Servicer has to modify the loan. Because the Special Servicer may not directly benefit from the terms of the modification of the loan, the fees generated in handling the loan may also be a motivating factor of the Special

Servicer. The fees generated in connection with the modification are kept by the Special Servicer and once the loan is modified, the loan is transferred back to the Master Servicer. As long as the Special Servicer complies with the servicing standard, the Special Servicer may be motivated to modify the loan, generate its fees and get the loan back to the Master Servicer.

Because many securitized loans maturing in 2009 had initial high loan-to-value ratios (i.e., many 1999 and 2004 vintage securitized loans had 75 to 80 percent loan-to-value ratios) with large balloon payments due on the maturity date (many 1999 and 2004 vintage securitized loans had 20 year principal amortization schedules or interest-only payment schedules), a loan modification to extend the maturity date may be a good option for both the property owner and the Special Servicer. Special Servicers are generally permitted to extend the maturity date, and, by doing so, the loan is moved out of "special servicing."

## OTHER ISSUES

Other factors to be considered for loans maturing in 2009 include evaluating the "debt stack" of the property, understanding the loan guaranty terms and evaluating bankruptcy options. If a project is subject to a primary mortgage, a mezzanine loan and third party equity, then the property owner must evaluate what limitations the mezzanine lender or third party equity provider has in place. Generally, each member of the "debt stack" will need to consent to any modification. Thus, property owners must anticipate the



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delays that will be caused in getting consents from everyone in the "debt stack". For many securitized loans, the loan is non-recourse (i.e., there is no individual guarantor guarantying payment of the loan) but subject to limited non-recourse carve-out guaranties. If a loan is in default or placed in special servicing, the lender/Special Servicer will closely review the non-recourse carve-out guaranty to verify if any "bad boy" event has occurred that triggers personal liability of the guarantor. Thus, prior to engaging the Special Servicer to discuss a loan modification, a property owner and all principals subject to a guaranty should carefully review the property records and confirm that there are no potential defaults under the non-recourse carve-out provisions of the loan guaranty. Finally, property owners may need to determine if bankruptcy is an option to protect equity in a project if a lender is

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unwilling to come to a mutually acceptable modification of the loan; however, the filing of bankruptcy is generally a non-recourse carve-out, which can trigger full liability under the loan.

Property owners facing maturity of their loans over the next 18 months must begin planning their exit strategy now. A sale or a refinance may not be an option, and lenders and property owners will need to work together to come up with creative solutions. Before opening up negotiations with lenders, the prudent property owner will review the situation and come to the negotiation table armed with a proposal (or two) to get the project through the current credit crunch.

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