"Structural and Legal Issues in Commercial Mortgage Securitization Transactions"

Patrick C. Sargent

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The primary structural goal in an asset securitization or structured finance transaction is to isolate the assets or collateral which will generate the cash flow to investors. Outside credit risks or exposure should be removed to the greatest extent possible.

Typically, assets are transferred to a bankruptcy-remote special purpose entity (herein “SPE” or “Issuer”) that is limited in its governing articles to only that business which relates to the assets to be acquired and issuance of the securities backed by such assets. An SPE may be a corporation, limited liability company (“LLC”), partnership or trust. Consequently, the SPE should not be able to incur additional debt or obligations that might enable a creditor to bring action against the SPE which might interfere with payment to the investors.

The SPE also should be structured to reduce the possibility that a bankruptcy court, in a proceeding involving the parent or other affiliate, would order “substantive consolidation” of the assets of the SPE with those of its parent or affiliate. The transfer to the SPE should further be structured to be a true sale or other absolute conveyance in order that the assets will not be deemed a part of the transferor’s estate in the event of the transferor’s bankruptcy or insolvency. References in this article to bankruptcy laws will be to the United States Bankruptcy Code (the “Bankruptcy Code”). Commercial mortgage securitization began in the public market with dispositions by the Resolution Trust Corporation in 1991. With this start, many commercial mortgage lenders have originated commercial mortgage loans which are then pooled into a securitization. Commercial mortgage-backed securities (CMBS) in the U.S. have increased to over $400 billion outstanding in 2004, with new origination of approximately $70-80 billion per year.

This article discusses structural and legal requirements, certain opinions that typically are requested from the Issuer of securities backed by such assets, and certain other considerations regarding pooling and servicing agreements, trust indentures, credit enhancement, and underlying documents in the transactions. The discussion does not cover several significant issues facing issuers such as those arising under federal and state securities laws, the Investment Company Act of 1940, and federal income tax laws and regulations (including those relating to Real Estate Mortgage Investment Conduits, or “REMICs”), or the laws of the jurisdiction of the Issuer or SPE if other than the United States.

1. Creation of Bankruptcy Remote Entity. In commercial mortgage conduit programs, the SPE criteria and substantive consolidation concerns arise at two levels: first, at the issuer/depositor level where the mortgage assets are being pooled, and second, at the borrower level, that is, the owner of the property and obligor on the mortgage loan. A pool of loans to a single borrower or small group of borrowers merits close attention to the SPE criteria and delivery of a non-consolidation opinion (discussed below) with respect to each borrower. As the pool increases in size and borrower diversity, the severity of the impact of substantive consolidation with respect to a single borrower on the pool as a whole diminishes. Consequently, while an SPE should be used whenever possible, the additional requirements of an Independent Director and non-consolidation opinion may be waived with respect to each borrower if the pool is statistically diverse (for example, the loan represents less than 5% of the entire pool). A pool with borrowers that do not meet the SPE criteria may require higher levels of subordination in order to obtain the desired ratings, thereby reducing the economics of the securitization.

The Issuer/SPE should satisfy the following criteria:

- **Limited Purpose.** The corporate charter, partnership agreement, LLC agreement or trust document, as the case may be (“organizational documents”), should limit the business and operation of the Issuer to (i) activities related to acquisition and holding of the specific property/mortgage assets, (ii) issuance of the securities and (iii) other activities necessary and

appropriate to carry out the foregoing. Similarly, the organizational documents of each SPE borrower should limit its business and operations to (i) acquisition, ownership and operation of the specific property, (ii) incurrence of the debt represented by the mortgage, and (iii) other activities necessary and appropriate to carry out the foregoing.

- **Indebtedness.** The Issuer should be restricted from incurring additional indebtedness unless: (i) such debt would not result in a reduction of the current rating, (ii) such debt is fully subordinate to the rated debt and meets other limitations on payments and pursuit of remedies as may be required by the rating agencies or (iii) such debt is rated at the same or higher level as the existing rated debt and would not impair the current rating. With respect to an SPE borrower, the restrictions on debt should be limited to the related mortgage and normal trade accounts payable - exceptions should be approved on a case by case basis only.
- **Charter Provisions/Independent Director.** So long as the securities or mortgage loan, as applicable, remain outstanding, the Issuer/SPE should have at least one director who is not, and has not been for at least five years preceding such selection, an officer, director, shareholder, partner, member, significant customer or supplier of the parent or any affiliate, or a family member of the foregoing ("Independent Director"). The organizational documents should restrict the Issuer/SPE's ability to (i) amend the limitations set forth in the organizational documents, (ii) dissolve or liquidate prior to payment in full of the securities/loan, or (iii) merge with any entity or transfer all or substantially all of its property or assets, except under certain limited conditions. Any such action must be approved by a unanimous vote of the SPE's directors, including the Independent Director(s). Any voluntary filing under insolvency or bankruptcy laws by the SPE must be approved by all the SPE's shareholders, partners, or members, as applicable, and the entire board of directors, including the Independent Director. [Note: provisions prohibiting a voluntary bankruptcy filing are generally considered unenforceable as against public policy; consequently, the Independent Director vote is utilized to reduce the risk of an unintended voluntary bankruptcy filing.] If the SPE is a partnership or LLC, then there should be a corporate general partner or member that is also an SPE and which has an Independent Director. Certain other options are available for LLCs in limited jurisdictions, such as Delaware.
- **Separateness Covenants.** The operation of the SPE should be governed by "separateness" covenants (generally included in organization documents and loan agreements or indenture) designed to maintain the integrity and recognition of the SPE as a separate entity:
  - Maintain adequate capital in light of its anticipated business operations.
  - Maintain its books and records separate and apart from those of any other person, including its parent and affiliates.
  - Not commingle its assets or funds with those of any other entity.
  - Hold itself out to the public as a separate and distinct entity.
  - Maintain separate financial statements.
  - Prepare separate tax returns to the extent required by applicable law.
  - Hold regular meetings and observe all entity formalities.
  - Correct any known misunderstandings as to its separate identity.
  - Not guarantee or become obligated for the debts of parent or any other entity; nor permit any affiliate to guarantee or pay obligations of the SPE (other than certain customary limited indemnity obligations).
  - Maintain an arms-length relationship with affiliates, and any affiliate transactions shall be fair, commercially reasonable and pursuant to written, enforceable agreements.
  - Any overhead shared with affiliates will be fairly and appropriately allocated and charged.
  - Conduct business in its own name and use its own stationery, accounts, checks, and invoices.
  - Pay its obligations out of its own funds.

References: Eastgroup Properties v. Southern Motel Association, Ltd., 935 F.2d 245 (11th Cir. 1991); Union Savings Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.), 860 F.2d 515 (2d Cir. 1988); In re Bonham, 229 F.3d 750 (9th Cir. 2000); In re Central European Industrial Development Company LLC, 288 B.R. 572 (Bankr. N.D. Cal. 2003); Special Report by the TriBar Opinion Committee, Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions, 46 Business Lawyer 717 (1991); Sargent, Bankruptcy Remote Finance Subsidiaries: The

Substantive Consolidation Issue, 44 Business Lawyer 1223 (1989). For an illustration of how SPEs and Independent Directors should not function, see In re Kingston Square Associates, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

The foregoing SPE criteria often must be accompanied by an opinion of counsel to the SPE that a court in a bankruptcy proceeding concerning the parent or other affiliate of the SPE would not consolidate the assets and liabilities of the SPE with those of the debtor parent or affiliate (referred to as "substantive consolidation").

In general, the criteria for SPEs is established by rating agencies and may be updated or modified from time to time. For example, Standard & Poor's Ratings Group has published its criteria for conduit pools indicating that borrowers generally should be structured as SPEs, but that independent directors and non-consolidation opinions are not required where the loan is less than $20 million or represents less than 5% of the pool. Prudent lenders and originators should recognize the benefits of using an SPE for non-recourse lending, including expedited treatment for lenders in single-asset cases under the Bankruptcy Code.

Lenders providing non-recourse mortgage financing often require the parent, sponsor, or principal of the SPE borrower to guaranty or indemnify the lender for losses arising from certain "non-recourse carveouts," typically related to bad acts by the borrower; e.g. fraud, misapplication of funds, and violation of environmental laws. The scope of non-recourse carveouts has sometimes been expanded to include violation of SPE criteria, and other matters deemed significant by the lender. In some cases the debt becomes a full "springing" obligation of the non-recourse carveout guarantor in the event of a voluntary or collusive involuntary bankruptcy filing by or against the SPE borrower. While this can be an effective deterrent for borrowers trying to frustrate the efforts of a lender realizing on the only collateral it bargained for, it may also present challenges to counsel called upon to render the non-consolidation opinion.

2. True Sale vs. Pledge. The securitization transaction should be structured to ensure that the SPE has complete and absolute ownership of the assets used to secure the securities issued. Accordingly, the transfer of the assets from the parent/affiliate to the SPE should be treated as a "true sale", or, if made as a capital contribution, an "absolute conveyance." Similarly, in pass-through transactions the transfer by the depositor into the REMIC trust must also be treated as a true sale. An opinion of counsel generally will be required to the effect that, in the event of a bankruptcy proceeding involving the transferor, such assets will not be deemed property of the transferor under Section 541 of the Bankruptcy Code. Applicable state law determines the extent of a debtor's interest in property; bankruptcy law determines whether that interest constitutes "property of the debtor's estate." Factors considered by the courts in determining whether or not the transferor retains any equity ownership in the assets transferred to the SPE include the following:

- The amount of recourse to the transferor; any amount in excess of historical losses may cause the transaction to be viewed as a secured pledge.
- Which party bears the risks and enjoys the benefits of ownership of the assets? This test normally incorporates other factors such as recourse and rights to residual or any excess proceeds.
- Whether fair value has been received for the assets conveyed.
- Whether the seller retains any rights in or control over the assets (e.g., right of substitution, redemption or repurchase).
- Whether collections from the transferred assets are segregated from any other assets that may be held by or retained by the transferor. If transferor acts as servicer, a detailed servicing agreement with customary terms and provisions should be executed and segregated accounts used.
- How the parties treat the transaction for tax, accounting and regulatory purposes.
- The intent of the parties, particularly as indicated by the express language of the documents.
- Disclosure of the transaction and its effect to third parties.

References: Major's Furniture Mart, Inc. v. Castle Credit Corporation, Inc., 602 F.2d 538 (3rd Cir. 1979); In re Major Funding Corporation, 82 B.R. 443 (Bankr. S.D. Tex. 1987); Fox v. Peck Iron and Metal Company, Inc., 25 B.R. 674 (Bankr. S.D. Cal. 1982); Carter v. Four Seasons Funding Corporation, 97 S.W.3d. 387 (Ark. 2003); A.B. Lewis Co. v. Nat'l Investment Co. of

Houston, 421 S.W.2d 723 (Tex. Civ. App. – 14th Dist. 1967); Resolution Trust Corp. v. Aetna Casualty and Surety Co. of Illinois, 25 F.3d 570, 578 (7th Cir. 1994); In re Royal Crown Bottlers of North Alabama, Inc., 23 B.R. 28 (Bankr. N.D. Ala. 1982) (addressing 'reasonably equivalent value' in transfer by parent to subsidiary); Butner v. United States, 440 U.S. 48 (U.S. 1979); In re Schick, 246 B.R. 41, 44 (Bankr. S.D.N.Y. 2000); (state law determines the extent of the debtor's interest; bankruptcy law determines whether that interest is "property of the estate"); see also Delaware Asset-Backed Securities Facilitation Act (2002), Title 6, Ch 27A, Delaware Code. The Texas Uniform Commercial Code provides a safe harbor for the sale of accounts, chattel paper, payment intangibles and promissory notes; See §9.109(e).

3. Fraudulent Conveyance/Transfer. In some instances, it may be necessary to provide comfort that the transaction would not be deemed a fraudulent conveyance or fraudulent transfer under applicable law (for example, Section 548 of the Bankruptcy Code). The need for comfort on this issue increases as the parent/transferor's credit approaches investment grade or lower. Section 548 provides that the bankruptcy trustee may avoid any transfer if the debtor: (1) made the transfer with actual intent to hinder, delay or defraud any creditor; or (2) received less than a reasonably equivalent value in exchange for such transfer and either (a) was insolvent at the date of transfer or became insolvent as a result thereof, (b) was engaged in business for which its remaining capital was unreasonably small, or (c) intended to incur debts beyond its ability to pay.

A legal opinion may be required, and it typically assumes or relies solely on outside evidence of the foregoing highly factual (as opposed to legal) points. Accordingly, underlying certificates or other evidence as to (i) the intent of the parties (i.e., no intent to hinder, delay or defraud creditors), (ii) the solvency of the transferor and (iii) the fair value of the consideration received for the property transferred are more important than the opinion itself. The fair value certificate should come from a valuation expert, which may include the underwriter or placement agent involved in the offering. MAI appraisals of the property are also competent third-party evidence as to value.

4. Other Legal Opinions. Opinions of counsel to the Issuer generally must be rendered regarding the following matters:

- Legality/Enforceability. That all documents relating to the transaction (i) are legal, valid, binding and enforceable in accordance with their terms, (ii) have been duly authorized, executed and delivered by the Issuer (and the parent or other transferor, with respect to the transfer of assets to the Issuer) and (iii) do not conflict with or violate the Issuer's organizational documents, bylaws or any agreements or orders by which it is bound, or any applicable laws or regulations. Such documents include the following:
    - Sale/Transfer Agreement (covering conveyance of assets)
    - Pooling and Servicing Agreement (for pass-through structure); or Trust Indenture (for debt structure)
    - Mortgages/Leases/Loan Agreements
    - Other security or collateral agreements
- **Security Interest/Perfection.** An opinion that the trustee will have a first perfected security interest in all assets comprising the trust estate which are pledged or transferred to the trustee for the benefit of the investors.
- **Credit Enhancement.** Similar opinions also are required from appropriate counsel with respect to any credit enhancement documents such as letters of credit, insurance policies, surety agreements, master leases or guarantees. (See discussion below).
- **Foreign Jurisdiction Matters.** Other opinions may be required from counsel in the jurisdiction where the Issuer or other parties reside or where the assets are located that deal with structure, authorization, legality, procedure and rights of the trustee to realize upon the collateral. The nature and scope of these opinions will depend upon the specifics of the transaction and issues that are flushed out during the structuring and due diligence phases.

5. Issues Relating to the Mortgage Loans and Properties. Consideration should also be given to the mortgage loans and related property collateral in the securitization with respect to the following issues, which are often addressed in representations and warranties made by the seller/originator of the loans:

- Hazardous waste and environmental matters: e.g., Environmental Site Assessments (Phase I reports) are required, and any remedial action called for therein should be completed or satisfactory operations and maintenance programs and escrows should be in place; also, default provisions and representations and warranties regarding compliance with environmental laws should be contained in the operative documents. In some cases, environmental insurance may be obtained to address specific contamination issues, or even broader coverage under a secured lender policy.
- Whether any restrictions on the property or requirements as to its operation or use should be imposed within the mortgage or are imposed by any governing authority (this may arise in connection with single asset or special use properties, regional malls, congregate care facilities, and condominiums).
- Status and credit of major tenants and any leasing agreements or criteria upon which the rating is based. Ratings based on the credit of a rated tenant require bondable, noncancellable leases. (See discussion below.)
- Recent, satisfactory MAI appraisals.
- Adequacy of insurance coverage, and the financial status of the insurance carrier. Coverage should include at a minimum: (i) "all risk" casualty insurance in an amount at least equal to the loan balance and sufficient to avoid application of co-insurance provisions; a "Replacement Cost" rider should be added with no reduction for depreciation; (ii) business interruption or rental loss insurance (12 month minimum); (iii) comprehensive general liability insurance; and (iv) flood and earthquake insurance, as appropriate. In addition, most lenders require terrorism insurance coverage, particularly for large loans in significant metropolitan areas. Insurance providers generally should meet minimum "A" rating for claims paying ability. Casualty insurance proceeds should be applied to restoration or to pay down the mortgage and the lender or trustee should oversee disbursement of funds.
- Subordinate debt, which generally should be prohibited. In limited instances (single asset or large loan transactions with low LTVs), debt for capital improvements may be permitted up to an established minimum. If other debt exists, a satisfactory subordination and standstill agreement should be in place.
- Acceptable debt service coverage and loan to value ratios and delinquency experience.
- Representations and warranties as to liens, title, title insurance, licenses, compliance with applicable laws and regulations (including usury, taxes, ADA and ERISA), property condition, and other matters.
- Adequate tax and insurance escrows, capital expenditure reserves, and tenant finish-out and lease-up reserves, as appropriate.
- Ground lease provisions (if applicable) and satisfactory ground lessor estoppel addressing consent to mortgage, notice and cure rights, status of fee, assignability, term (at least 20 years beyond mortgage maturity) and other matters.

More detailed listings of mortgage loan representations and warranties can be found in rating agency published materials; in addition, for examples of recent representations and warranties, check the SEC filings made by various publicly registered commercial mortgage loan securities issuers.

6. Trust Indenture/Trustees. A Trust Indenture may be used for a large single property transaction or a single borrower/multiple property transaction where the issuance of bonds or notes satisfies the needs of the Issuer and investors. The use of pass-through securities created pursuant to a pooling and servicing agreement (as discussed below), however, is more common. If the Indenture is utilized, parties should consider whether basic terms are satisfactory, including:

- Establish "Eligible Investment" criteria for investment of trust funds; should be highly rated instruments or U.S. government securities (i.e. cash equivalents).
- Require that all funds be held in a trust account segregated from other accounts and not commingled. Funds held in trust should be adequately collateralized pursuant to applicable fiduciary funds on deposit regulations (such as U.S. Office of the Comptroller of the Currency regulations at 12 C.F.R. §9.10(b)). The indenture should require immediate investment of funds into Eligible Investments that mature on or before the next payment date.

- The flow of funds within the indenture must be reviewed and determinations made as to the priority of distributions and limitations on trust payments, including: principal; interest; fees; expenses; subordinate classes; indemnities. Also the structure must be evaluated to determine whether the Issuer is entitled to receive excess funds after provision for specific reserve amounts or some other minimum cash reserve maintenance test.
- Redemption Provisions. Will there be any requirements for or limitations on early, optional or mandatory redemptions?
- Notice Requirements. Notice to certificateholders and rating agencies from the trustee generally should be required with respect to any default, failure to maintain minimum reserve amounts, proposed replacement of trustee, any event relating to existing credit enhancement, Issuer payment delinquencies and anything that alters or materially affects the transaction.
- Defeasance of securities requires deposit of collateral with appropriate maturities and a rating equivalent to or better than the securities being defeased. The calculation should be confirmed by independent public accountants.
- The role of the trustee is important in monitoring Issuer compliance with payment, reporting and document delivery obligations. The indenture should clearly stipulate all duties of the trustee. Typically, a “gross negligence” standard is not appropriate for a trustee in a structured finance transaction.
- There should be no limitation of trustee liability or indemnification by the trust if the trustee breaches its duties and obligations or is negligent in the conduct of its duties.
- The trustee should meet specific criteria, including minimum long-term debt rating of investment grade or higher, and a minimum capital and surplus, typically $50 million. In some instances the trustee may be called upon to act as a back-up servicer with an obligation to make debt service and property protection advances, in which case its long-term debt rating should be at least “A”.

7. Pooling and Servicing Agreement (PSA). The most common structure for CMBS transactions is creation of a trust that issues multiple classes of senior/subordinate pass-through certificates pursuant to a pooling and servicing agreement. The PSA will provide for conveyance of the mortgage loans by the depositor to the trust, issuance of the pass-through certificates, servicing of the mortgage loans, and the duties of the trustee. The trustee issues mentioned above apply, and the servicer obligations must be addressed as well. Consider the following:

- The mortgage loans should be conveyed to the trust together with representations and warranties by the seller/depositor (or other creditworthy person) relating to origination and other attributes of the mortgage loans, underlying properties and borrowers (see item 5. above). The seller/depositor must have a cure or repurchase obligation in the event of a breach.
- The trustee must review the mortgage file and confirm the contents within a reasonable period after closing.
- The master servicer typically will have advancing obligations to cover both borrower debt service (principal and interest payments) and property protection (taxes, insurance, ground lease payments, etc.). The advancing obligation should be through foreclosure and liquidation, subject to the servicer’s reasonable determination of recoverability. Transactions typically exclude debt service advancing for the “Appraisal Reduction Amount,” a calculation designed to estimate the anticipated principal loss on disposition and thus minimize the ultimate loss realized on the loan. However, the scope of advancing and the determination of and mechanism for recoverability continue to challenge the CMBS industry.
- Maintenance of a minimum rating or other credit criteria of the servicer is required. Generally, a long-term unsecured debt rating of not less than “A” is necessary for servicers who are required to advance. Rating agencies either publish master and special servicer ratings, or will require an approval of a servicer prior to rating a transaction since the servicing of the mortgages is a crucial aspect of the securitization.
- The master servicer and special servicer are bound to perform by an acceptable standard of care. Generally, the “servicing standard” requires that the servicers service the loans for the exclusive benefit of the certificateholders in the same manner and using the same skill and prudence as they would in servicing similar loans for third parties or for their own account, giving due consideration to customary practices of prudent institutional commercial mortgage lenders and with a view to maximization of the net present value of the mortgage loans. The servicing must be done without regard to potential conflicts arising from (i) the servicer owning any securities, (ii) its relation with any borrower, (iii) its compensation or right to charge fees, or (iv) any obligation to make advances.

- Detailed servicing and accounting records must be maintained for the mortgages; 30, 60 and 90 day delinquency and default status reports and monthly or quarterly rent rolls and operating statements should be provided to the trustee and rating agencies. The Commercial Mortgage Securities Association (CMSA) has developed an industry standard investor reporting package that is utilized in most securitizations (see www.cmbs.org).
- Collections should be remitted not less than monthly to the trustee. A segregated trust account in the name of the trustee should be utilized.
- Master servicer should not be able to resign or be removed until an eligible substitute servicer has been appointed. The trustee may be required to act as back-up servicer to the master servicer.
- Property inspections should be performed by or on behalf of the servicer on a regular basis (e.g. once/year and after 60 day delinquency).
- A special servicer is appointed to handle defaulted and troubled loans. The special servicer's authority to modify and reform loans should be detailed. Modifications to the amount or timing of payments, changes to the interest rate and extensions of the maturity are restricted. For any change, the special servicer must determine that the change will result in a greater realization on the loan on a net present value basis than would occur through liquidation. Extensions are limited (usually not more than a total of 3 years). In addition, an "Operating Advisor" or "Directing Certificateholder" representing the interests of the unrated first loss certificateholders will have input on the loan workout, but the ultimate decision must be made by the special servicer in accordance with the servicing standard. The Operating Advisor may have the right to replace the special servicer, subject to the replacement being approved by the rating agencies.
- There should be no limitation of servicer liability and no indemnification by the trust if the servicer breaches its duties and obligations or is negligent in the conduct of its duties.
- With the advent of more complex loan structures, the PSA provisions are being expanded to address the attendant duties and considerations. For example, a single large loan may be broken up into 2 or more "pari passu" notes and deposited into multiple securitizations. Thus, one PSA is typically designated as governing the servicing of that loan, and instructions for payments to the other noteholders, notice provisions, Operating Advisor and special servicer rights must be set forth. In addition, the large loan may be set up as an A/B structure, or have mezzanine debt, in each case imposing additional notice, consent and consulting rights.

8. Forms of Credit Enhancement. Various credit enhancement involved in rated transactions include: (1) internal: senior/subordinated structures, reserve funds and over collateralization; and (2) external: letters of credit (LOCs), guarantees, surety bonds, insurance policies. Consideration must be given to the legal and other criteria required for each of these types of credit enhancement:

- Senior/Subordinated Transaction.
  - Determine required levels of subordination.
  - Establish payment priority: may be super pay (where "A" class receives all payments first) or other levels of priority may apply, depending on structure and rating.
  - If a subordinate class is held by the seller, Issuer or an affiliate, "true sale" treatment may be adversely affected.
- Reserve Funds. Minimum amounts will be established and funded either at closing or through gradual build up from cash flow. Use will be restricted. Replenishment may be required.
- Letters of Credit.
  - Must be clean, sight draft without limits or other conditions to draw.
  - Minimum rating requirement for LOC Issuer. Require replacement within 30 days if rating drops, or draw on LOC.
  - Termination only upon substitution of satisfactory replacement LOC, or require trustee to draw if satisfactory replacement is not secured by 30 days prior to termination.

- Guarantees. Determine credit criteria for the guarantor and confirm absolute and unconditional payment obligation and other terms for guarantee. Note: guarantees may raise concerns in the substantive consolidation analysis, depending on nature and scope.
- Surety Bond or Insurance Contract. The rating of the insurance company or issuer of surety bond will be critical, as well as limits on the policy.

9. Credit Tenant Lease Structures. The hallmark of a credit tenant lease (CTL) loan securitization is reliance on a set income stream (the rent payments) to amortize the debt from a creditworthy source (the rated tenant). Thus, the owner of a commercial property with a credit quality tenant subject to a bondable, “hell or high water” lease may obtain financing at a rate based on the credit tenant’s rating and benefit from a debt service coverage ratio that may be as low as 1:1. The borrower’s loan is secured by a first mortgage on the property and assignment of the credit tenant’s lease, which should result in a rating on securities backed by the mortgage equal to the credit rating of the tenant.

This structure requires attention to two possible interferences with the income stream: first, the borrower must be a bankruptcy remote SPE meeting the criteria described above; second, the lease terms should eliminate the potential for termination of the lease by the tenant for any reason, abatement or reduction in the income stream, or any material obligations on the part of the landlord. Key provisions within the credit tenant lease include the following:

- Rental Income: The rent payment must be fixed (or increasing) through the term in an amount sufficient to pay monthly debt service on the mortgage. These payments must in turn be sufficient to pay annual servicer/trustee fees in the securitization and fully amortizing debt service on the rated securities. There can be no allowance for abatement, reduction or termination of rent payments for any reason, including casualty or condemnation.
- Operating/Capital Expenses: The tenant must be obligated to pay all taxes, insurance, repairs, maintenance, utilities and other operating expenses. Even capital expenditures such as roof, structure and parking must be borne by the tenant. The lease should obligate the tenant to pay for any future government-required additions (such as ADA, building code changes, etc.). Any possible monetary obligation by the borrower detracts from the credit lease structure.
- Term/Termination: The lease term must equal or exceed the full amortization period of the mortgage loan. The tenant should not have any contractual right to terminate the lease, even in the event of condemnation or casualty, unless that right is coupled with an obligation to submit a rejectable offer to purchase the property for a scheduled amount sufficient to pay all outstanding principal and interest on the mortgage. In some leases, the tenant is given the right to terminate if a substantial casualty or condemnation occurs during the final 2-5 years of the lease. In this case, either the term of the rated securities can be shortened to mature prior to this termination window, or other thresholds can be set so that insurance proceeds or other funds are sufficient to retire the remaining balance of the mortgage at that time.
- Insurance: The credit tenant should be obligated to purchase casualty insurance meeting the criteria described above, or in some instances may self-insure. Business interruption insurance would not be required since the tenant would not have an abatement right during casualties.
- Guarantee: If the tenant is not a rated entity, then an irrevocable guaranty from a rated parent or affiliate will be required which fully guarantees the lease payment obligation unconditionally and without reduction, limitation, offset or defense of any nature, regardless of any bankruptcy of the tenant or borrower. The securitization trustee should be the acknowledged assignee of such guarantee.
- Environmental Compliance: The tenant should directly undertake to comply and cause compliance of the property with all environmental laws. The borrower should be indemnified for any liability associated with non-compliance.

Some transactions will not fully comply with the foregoing CTL criteria (i.e., the leases are triple net or double net), but may nonetheless receive CTL treatment if satisfactory mitigants to CTL deficiencies are added. CTL deficiencies include casualty or condemnation termination or abatement rights; landlord obligations for structural repairs, maintenance and replacements; termination or abatement rights for breach of other landlord obligations such as environmental remediation, exclusive use or other restrictive covenants and compliance with local and federal law; and a balloon mortgage term. Mitigants to CTL deficiencies include requiring a higher debt service coverage ratio (e.g. 1.05:1); establishing capital reserves in excess of

estimated costs; and procuring casualty and condemnation termination/abatement insurance, residual value insurance, environmental insurance or other lease enhancement insurance policy.

References: Fitch, Inc., "Credit Tenant Lease Loans," (April 22, 1999) www.fitchibca.com; Standard & Poor's Ratings Group, "U.S. CMBS Legal and Structured Finance Criteria – Credit Tenant Loan Transactions," (May 1, 2003) www.standardandpoors.com. For a discussion of "true lease" characterization issues in bankruptcy, see Homburger & Andre, Real Estate Sale and Leaseback Transactions and the Risk of Recharacterization in Bankruptcy, 24 Real Property, Probate and Trust Journal 95, (1989); see also, In re Integrated Health Services, Inc., 260 B.R. 71 (Bankr. Del. 2001); HSBC Bank v. United Air Lines, Inc., 317 B.R. 335 (N.D. Ill. 2004).

10. Mortgage Loan Defeasance. Loans often contain a lockout provision prohibiting prepayment during a specified period (3 to 6 years) in order to limit adverse yield consequences to investors and enhance the value of interest-only classes. To offset this restriction on borrowers, the loan documents may permit a defeasance of the loan and release of the property during the lock-out period. Defeasance provisions should require at least four elements: (i) borrower must provide U.S. government securities as replacement collateral in an amount sufficient to generate cash for loan payments as/when due under the note, (ii) independent accounting firm should certify that the collateral is sufficient to pay note in accordance with its terms, (iii) the loan must be assumed (and collateral owned) by an entity meeting SPE criteria, and (iv) counsel must provide an opinion that the trustee has a perfected security interest in the new collateral. In some cases an additional opinion as to compliance with REMIC regulations will be required.

Under defeasance provisions, the SPE borrower either would sell the property and hold the collateral itself, or create a new SPE to hold the collateral and assume the loan. However, the issuer/sponsor or servicer of a securitized pool of loans typically creates or causes creation of a single loan assumption SPE to assume all loans and all collateral for the defeased loans in that pool; the benefits include: (a) lower defeasance transaction costs, (b) easier administration by servicer, (c) lower risk of the borrower neglecting state franchise fees or taxes or other entity requirements, and (d) avoiding possible substantive consolidation or other bankruptcy risk with the initial borrower or its principals.

11. Subordinate Debt/Mezzanine Debt/Preferred Equity. In an effort to get more proceeds from a loan financing, borrowers turn to one of several methods currently utilized for securitized loans:

- Subordinate Debt: The SPE borrower generally should not have subordinate debt (secured or unsecured) in order to maintain the bankruptcy remoteness desired and avoid the need for the mortgage holder to contend with multiple creditors if a bankruptcy ensues. If subordinate debt is permitted, a subordination and standstill agreement should be executed wherein the subordinate debt lender agrees: (i) not to pursue bankruptcy proceedings against the borrower (i.e., a "no-petition agreement"), (ii) that payments on sub debt may be made only from excess cash flow after debt service, operating expenses and reserves, (iii) to waive rights to declare default or pursue remedies so long as senior debt is outstanding and for applicable preference period thereafter, and (iv) to assign its voting rights in bankruptcy to first lien mortgagee.
- Mezzanine Debt: This debt is generally incurred by the parent/partners of the SPE borrower and is secured by a pledge of the ownership interests in the SPE borrower. Thus, the SPE borrower itself does not incur additional debt, though payments are made from excess cash available from the SPE borrower as a distribution to its equity owners. The mezzanine lender/pledgee of the SPE equity should be pre-approved as a "permitted transferee" of the equity interests in the SPE borrower (per transfer restrictions contained in the mortgage).
- Preferred Equity: The lender providing the additional capital may characterize its loan as a preferred equity position in the SPE borrower with preferences on distributions and a preferred return. The owner of the preferred equity position may bolster its rights by having certain control features on the SPE borrower if minimum cash flows are not achieved.

Of the foregoing options, subordinate debt at the SPE borrower level is least desirable.

Borrowers may obtain greater loan proceeds through an A/B note structured loan, wherein the same mortgage secures both the senior A note and a subordinate B note. The subordinate B noteholder demands a higher interest rate, but accepts the limited rights and remedies that are necessary for the securitized A note. In general, the B noteholder has limited cure rights, but may purchase the A note at par after a default.

12. Withholding Taxes. The law of the jurisdiction of the Issuer may provide for withholding taxes on payments of interest to foreign investors. While many international transactions incorporate an obligation of the Issuer to "gross-up" the interest rate or make "additional payments" to investors so that the net amount received after such withholding is not less than the return set forth in the security, this obligation may have an adverse impact on the rating of the securities. The future imposition of such a withholding tax is not quantifiable and, therefore, makes rating the securities difficult. Higher coverage ratios or other credit criteria may be necessary to cover the possibility of this additional payment obligation. Moreover, if securities of U.S. issuers are offered or sold to foreign investors, a host of other issues arise that are beyond the scope of this article, but which may have a significant impact on the transaction.

13. Governing Law. The transaction documents must specify the law governing the transaction, how disputes will be resolved and the language which will be binding in the event of multiple translations (in cross border transactions). Special provisions should be made for selection of a forum for dispute resolution (e.g., New York City federal courts), submission by all parties to such jurisdiction, provision for service of process, and waiver of inconvenient forum or other similar defenses. The location of the property securing the debt generally will govern at least the foreclosure or other remedial action that may be taken, and may govern certain other aspects of the transaction (for example, the determination of whether a "true sale" has occurred).

The foregoing comprise certain structural and legal considerations that should be addressed in securitization transactions and reflect the perspective of underwriters and rating agencies in reviewing terms and requirements. Apart from this discussion, any securitization transaction will also involve significant issues arising under federal tax laws (including compliance with REMIC rules), state and federal securities laws, the Investment Company Act of 1940 and the Trust Indenture Act of 1939. Prospective sponsors and issuers should consult with competent legal counsel before pursuing these transactions.

Additional references: "U.S. CMBS Legal and Structured Finance Criteria," Standard & Poor's Ratings Group (May 1, 2003); CMSA website, www.cmbs.org.