Chapter 11

CRE Loan Servicing in CMBS 2.0: the Legal Issues

James A. Spencer,

Partner, K&L Gates LLP

11.1 Introduction

In the last edition of this title, in 2012, a view point was taken that loan servicers were front and centre of European CRE loan workouts and restructurings in the post GFC era and their role would become increasingly more challenging, as a significant proportion of existing European CRE debt was expected to go into default as borrowers faced the consequences of being over-leveraged.

A lot has happened in the intervening period and the purpose of this Chapter is not to recount those various events. However, a number of themes do warrant mention. Since 2012, liquidity has, generally speaking, returned to the real estate lending market and underlying real estate values have seen a marked increase. The consequences have been twofold. On the one hand, a large number of legacy CMBS loans have been refinanced by the existing sponsors taking advantage of the availability of attractive debt pricing. On the other hand, special servicers (or indeed borrowers working consensually with the loan servicers) have been able, without the pressure of a fire sale type scenario, to dispose of underlying real estate and, whilst a number of deals have seen write-offs on an individual loan basis, those write-offs have generally been smaller than they would have been in 2012, due to the general rise in asset values. In short, performing loans in legacy CMBS deals have largely been refinanced whilst non-performing loans have either seen write-offs following workouts, enforcement or distressed sales or continue to be worked-out. By way of illustration, in the two year period ending June 2016, the number of loans remaining in legacy European CMBS transactions nearly halved.[1] This Chapter in the prior edition of this book looked at,[2] given where we were in the cycle at that time, the various

1 As at June 2016, the number of loans remaining in CMBS was 159, compared to 279 in July 2014—Information taken from Debtwire's "Debtwire Report: European CMBS Monthly Activity" reports dated July 2016 and September 2015.

2 See further Petersen, A.V., *Commercial Mortgage Loans and CMBS: Developments in the European Market*, 2nd edn (London: Sweet & Maxwell, 2012), Ch.7.

enforcement methods of servicers and those can be revisited in that edition without further discussion in this Chapter.

As discussed in Chapters 1 and 4, despite early promise, CMBS 2.0 issuance has proved modest, with German multi-family, Italian multi-loans, and English single loan deals leading the way. The role of the servicer in new CMBS 2.0 has changed but not in any dramatic way, with the introduction of greater reporting obligations, increased interaction with noteholders, the ability to dispose of the underlying loans as a tool to maximise recoveries, and a clearer framework for dealing with property protection advances, to name a few.

This Chapter will explore the role of loan servicers, their duties, obligations and rights and the key provisions of their appointment in the current vintage of CMBS 2.0 deals and will highlight some of the key differences to legacy CMBS deals.

11.2 Loan servicing and the role of loan servicers

11.2.1 What is loan servicing?

As described in the previous two Chapters, loan servicing is the process of administering, managing, collecting on and realising CRE loans and is divided into two functions: primary servicing and special servicing. Primary servicing refers to the process of collecting payments from the underlying borrower and applying those payments to the relevant creditors; put simply, cash collection and cash payment. In addition, primary servicers are responsible for the general administration of the loan, dealing with communications received from the borrower, monitoring compliance and reporting on loan performance to the finance parties and (in the securitised deals) certain of the securitisation parties.

Special servicing refers to the more ''intensive care'' aspects of loan servicing. Once a loan is transferred from primary servicing to special servicing, the special servicer will be responsible for dealing with non-payment and other material breaches of the underlying finance documents and for determining, and then implementing, the chosen strategy to workout or enforce the loan and its related security. Whilst a loan is being specially serviced, the primary servicer continues to carry out its role of cash management, but its duties to communicate with the borrower will vest in the special servicer.

11.2.2 Appointment of CMBS servicers

Servicers are appointed at the time a CMBS transaction is closed to service all the CRE loans securitised within that transaction on behalf of the CMBS issuer (as owner of, and lender under, those CRE loans) and the CMBS issuer security trustee (as holder of all security granted by the issuer over the loans and its other assets for the benefit of the CMBS noteholders). To carry out this role, the issuer will appoint the servicer as its agent and lawful attorney to exercise all the rights and remedies the issuer has as lender under the finance documents and, in the case of A/B loans (discussed further in Chapters 5, 6 and 7), as senior lender under the intercreditor arrangements.

CRE loans are, as discussed in Chapter 4, typically structured as syndicated loan facilities, with a facility agent being the link between the borrower and the syndicate of lenders and with a security trustee holding the security granted by the borrower on trust for the syndicate. In legacy CMBS deals, the servicer was also appointed by the facility agent and security trustee as their agent and lawful attorney to carry out and perform their duties and exercise all rights available to them under the finance documents and any relevant intercreditor arrangements. In CMBS 2.0, some deals have adopted the same approach, whereas others deals have kept the role of the facility agent and the security trustee outside the scope of the servicer/special servicer. The rationale for this is mainly because the role of the facility agent and security trustee are self-contained and, given that the identity of the facility agent and security trustee on loans marked for CMBS are typically the same entity as that which will act as servicer and special servicer on the CMBS,[3] there is no real need for that entity to appoint itself to perform that role. Where the servicer and special servicer are not appointed by the facility agent and security trustee, the facility agent and security trustee will typically still enter into the servicing agreement in order to agree to provide certain information to the securitisation parties (such as the agent providing its determination of LIBOR for the loan where LIBOR on the notes is to be pegged to the same rate (thus avoiding any basis rate risk), providing debt service calculations to the servicer and acting on the servicer's instructions with regard to making payments to the issuer).

Whilst the issuer delegates absolutely all its rights and duties to the servicer, it does not follow that the servicer is entitled to exercise such rights and duties within its absolute discretion, nor, without boundaries or limitations. The issuer (together with the facility agent, the security trustee and the issuer security trustee) will enter into a servicing agreement with the servicer and special servicer that sets out in detail what the servicer and special servicer can and cannot do in respect of the loans. The next few sections of this Chapter will discuss this in greater detail.

Servicers are granted powers of attorney from the issuer (and, where relevant, the facility agent and security trustee) and these powers of attorney are an integral part of the servicing documentation. The power of attorney typically appoints the servicer to act as the appointer's attorney in con-

[3] In legacy CMBS deals, the underlying facility agent and security agent was often the originating bank.

nection with all loans owned within the particular CMBS, but this power of attorney typically does not list or otherwise identify on its face which specific loans the power of attorney applies to. Whilst this approach avoids the power of attorney being cumbersome in a multi-loan CMBS transaction, it can also have the unwanted outcome of borrowers and other third parties querying or being reluctant to accept that a particularly power of attorney gives the servicer authority in respect of a specific loan. Moreover, these powers of attorney may not be sufficient or effective to enable servicers to execute all acts they may need to carry out in the discharge of their duties. This is particularly relevant for special servicers who may be taking local law enforcement action under a servicing agreement power of attorney which is often English law governed. For example, executing land charge enforcement documentation in Germany will require the special servicer to be armed with a German language and German law vollmacht (power of attorney) which on its face clearly relates to the relevant loan.

11.2.3 Servicing standard

As set out in the previous two Chapters, a standard feature in all servicing agreements is the obligation on the servicer to act in accordance with the servicing standard at all times. The servicing standard is one of the key principles of loan servicing, providing a benchmark against which a servicer's performance can be judged. Whilst the definition of servicing standard differs from deal to deal, CMBS 2.0 servicing agreements generally place an obligation on the servicer to service the CRE loans (i) first and foremost in accordance with all applicable laws, (ii) in accordance with the terms of the loan finance documents, (iii) in accordance with the terms of the servicing agreement and other securitisation documents to which it is a party, (iv) in the best interests of the issuer, (v) acting to a standard of care and skill which is the higher of that which it would service its own portfolio of CRE loans and that which it applies to third party CRE loans, but in each case taking into account the customary and usual standards of practice of a prudent lender of CRE loans, and with a view to the timely receipt of payments due in respect of the loans and, if a loan event of default is continuing, the maximisation of recoveries to the creditors on or before the final note maturity date.

If there is any conflict between any of these requirements, then they will apply to the servicer in the order of priority in which they are stated. Thus, for example, the servicer can't be required by the terms of the servicing agreement to do anything which would cause a breach of law, nor would the servicer be in breach of the servicing standard if it refused to take a particular course of action which a third party servicer would take if taking that action would not be in accordance with the terms of the finance documents. It is sometimes debated if an obligation on the servicer to act in the best interests of the issuer infers any greater duty than acting to the standard of care stated in (v) above, and thus a servicer may want that best interests requirement to itself be subject to the reasonable judgment of the servicer or to rank below the standard of care requirement.

Where a loan is tranched, the servicer will be required to maximise recoveries to the issuer and the junior lender as a collective whole, but taking into account the subordination of the junior lender. Whilst the servicing standard will typically rank the intercreditor agreement in priority to the servicing agreement, it is sometimes the case that the intercreditor agreement will state that, in the case of conflict with the servicing agreement, the servicing agreement will prevail (effectively overriding the conflict priority set out in the servicing standard).

As mentioned in the prior edition of this Chapter, some market participants were of the view that servicers should act in the best interests of, and maximise recoveries for, the noteholders. The market has not, however, adopted this approach. Nevertheless, as will be touched on in greater detail later in this Chapter, servicers do now have greater rights and responsibilities under CMBS 2.0, particularly in relation to the maturity of CMBS notes, to communicate with the noteholders and take their opinions into account. This may be considered as the right balance of informing the servicer of the views and thoughts of the noteholders (as a whole) at a time when their notes are due to mature, without unnecessarily hindering the servicer from performing its primary obligations of servicing the underlying loan portfolio by requiring it to evaluate (through the complex securitisation waterfalls) how decisions made at the loan level will impact each of the varying classes of noteholders.

If the servicer is instructed by the issuer, the issuer security trustee or, where relevant, the noteholders in accordance with the terms of the servicing agreement, to take a particular course of action, then the servicer is obliged to take that action regardless of whether or not it is consistent with the servicing standard (and as such the servicer can not be liable to any party for taking such action). However, servicers should seek a carve-out from that obligation such that they are not obliged to act if doing so would be illegal or likely to result in the servicer being subject to any claim or proceeding from another party.

A second important feature of the servicing standard is that it lays down the parameters for how the servicer must act in connection with any conflicts that may arise between its own interests and those of the issuer and other parties it represents. The servicing standard makes it clear that in the discharge of its duties, the servicer cannot have regard to any fees or other compensation to which it may be entitled, nor any relationship it or any related entity has with any other party to the CMBS or underlying loan, nor any ownership interest it or any related entity has in any underlying loan or in the CMBS notes. In essence, the servicer should, at all times, place the interests of the creditors above its own interests and the interests of its related entities. Whilst in practice it is often difficult for servicers to totally separate and disregard their own interests when making decisions, what should never be allowed to happen is servicers acting solely in their own best interests. By way of illustration, entities affiliated to the servicer on any particular deal may hold either junior classes of notes in that CMBS or hold (outside the CMBS) junior tranches of the underlying loans and so this element of the servicing standard is of paramount importance to protect the CMBS noteholders as a collective whole.

11.2.4 Cash collection, insurance and property protection

As mentioned above, the primary servicer will typically remain responsible throughout the life of a loan for collecting payments from the underlying borrower and then distributing those payments to the finance parties. Where the loan is tranched, this will typically involve paying the collections into a tranching account and then applying those collections in accordance with the priority of payments agreed between the senior lenders and junior lenders. In the case of a securitised loan, the servicer will pay amounts due to the CMBS issuer into the issuer's collection account. At this point, the responsibility for dealing with cash passes to the CMBS cash manager, who will distribute all amounts paid to the issuer to the noteholders and other securitisation parties in accordance with the securitisation priority of payments. As such, it should not be the responsibility of the servicer to concern itself with how loan level collections will be distributed at the CMBS level.

Servicers are also bound by fairly specific obligations relating to property insurance and property protection. Servicers must have procedures in place to monitor a borrower's compliance with its insurance obligations under the finance documents and must, to the extent of the finance parties' rights under the finance documents, cause the borrowers to comply with such insurance obligations. If a borrower is in breach of any of its insurance obligations, if the property or rental income is not insured or any policy is likely to lapse, then the servicer is obliged to use commercially reasonable efforts, subject to the servicing standard, to procure those obligations are complied with. In practical terms, assuming the borrower is not working with the servicer to remedy the situation, a servicer is most likely to first look to utilise funds standing to the credit of any of the borrower's bank accounts over which the security trustee has signing rights to pay any premiums to put such insurance in place (and is given the right to do so in the servicing agreement) and secondly it may look to make a property protection advance (discussed in more detail below) in order to do so.

As discussed above, servicers are given the right to pay amounts owed by the borrower to third parties in relation to the property, such as insurance premiums, headlease amounts, and any other amounts which in the servicer's opinion are required to protect the rights of the finance parties, from amounts standing to the credit of the blocked bank accounts of the borrower. If those accounts have insufficient funds to make the relevant payment (sometimes referred to as a property protection shortfall) and the servicer is of the opinion that it would be better in the interests of the issuer to make the payment than for it not to be paid, then the servicer is permitted to make a property protection advance by utilising one of four sources of funds—it may utilise its own funds (but there is no obligation on it to do so), it may request the cash manager releases funds from the issuer's collection account, it may request the cash manager requests a property protection drawing (from the liquidity facility provider) or it may raise funds from third parties.

Most third party European servicers do not have significant balance sheets nor lending platforms from which to fund a property protection advance themselves. If they did, then any such advance should be repaid in full on the next note payment date in the same position in the waterfall as the servicer's fees get paid, together with interest thereon (typically at the class A note interest rate). Whilst the servicer is given full authority to raise monies from third parties (and to cause such monies to be paid senior to amounts owing to the noteholders) if it considers doing so would be in accordance with the servicing standard, it is generally considered that a servicer would be reluctant to cause the issuer to be indebted to third parties and, given the immediateness in which a servicer would want to remedy such a shortfall, it would be unlikely that any third party loan could be documented and implemented that quickly in any event.[4] Thus a servicer would most likely look to the issuer's own bank accounts or to a property protection drawing to fund the property protection shortfall. If a servicer makes a property protection advance it is obliged to take reasonable steps to recover those from the borrower.

11.2.5 Reporting and provision of information

One of the primary servicer's main functions is reporting and the servicing agreement will impose a large number of obligations on the primary servicer (and, in some cases, the special servicer) to provide various parties with significant amounts of information. This section summaries these various reporting and other provision of information obligations.

In CMBS transactions, the servicer is obliged to periodically report to the note trustee, issuer and other key parties, in a standardised form, how the loan is performing (which in Europe typically follows the Commercial Real Estate Finance Council's European-Investor Reporting Package (E-IRP)). When a loan transfers to special servicing, the special servicer is required, in addition to the primary servicer's periodic reporting obligations, to provide an asset status report with respect to the securitised loan and underlying property within a specified period (usually 60 days) following the transfer of the loan into special servicing. The servicing agreement will prescribe the

[4] It is worth noting that any third party funding arrangement would be unsecured and must be made on a limited recourse and non-petition basis and thus there will be a smaller world of third party lenders willing to lend on such basis.

contents of such report, which will be negotiated on a deal-by-deal basis, but, together with information on the status of the loan and underlying property it will include a summary of the special servicer's recommended strategy and course of action that it has determined will maximise recoveries. The special servicer can update this report from time to time and must modify the report if any changes are required to its strategy by the servicing standard. Together these reports are of fundamental importance to the noteholders as their primary source of information on the underlying portfolio's performance.

In the context of CMBS deals the primary servicer is also responsible for preparing, on the CMBS issuer's behalf, notices to be issued to the market which disclose non-public information which is likely to have a material impact on the value of the underlying loans.

In September 2014 the EU Commission adopted Regulation (EC) No 1060/2009 which, together with its implementing measures (in particular Regulation (EU) No 2015/3), will impose from 1 January 2017 additional disclosure requirements for structured finance transactions. Pursuant to these regulations, the issuers of structured finance transactions are obliged to publically disclose to a website set up by the European Securities and Market Association (ESMA) all transaction documents, investor reports, loan level information and other key information in relation to the transaction. The consequence for servicers is that in new CMBS transactions the servicer is the entity most likely to be contractually appointed by the issuer as the designated reporting entity with regard to all loan-level information. Article 3 of Regulation (EU) No 2015/3 sets out the generality of the information to be reported and from a servicer's perspective it will want to ensure it is only responsible for the loan-level information (through the standardised disclosure templates annexed to Regulation (EU) No 2015/3), or, if it is also responsible for providing other relevant deal information, that its contractual obligation in relation thereto is limited to the extent it is provided with the required information from other transaction parties (who should be contractually obliged to provide that information to servicers). For deals that have closed since the implementation of these regulations but before 1 January 2017, it is likely that the servicing agreements for those deals will oblige the servicer to serve notice on ESMA that it is the designated reporting entity.

ESMA was required to issue technical instructions by 1 July 2016 detailing how the reporting will take place. However, at the time of writing, the latest announcement on the matter from ESMA is that due to certain issues with setting up the website, including lack of legal basis for funding, it is unlikely that the website will be available by 1 July 2017 and, accordingly, the technical instructions were not available on 1 July 2016.

The servicer will also be obliged to ensure that the loan facility agent exercises its rights to obtain, at the borrower's cost, an annual valuation of the underlying property and, in some cases, upon a disposal of any part of the property or its compulsory purchase. The valuation will be used to determine if the real estate would be insufficient to pay all amounts owing under the loan finance documents (if it is insufficient, this is known as an appraisal reduction) and such appraisal reduction would typically result in a reduction in the commitment of the liquidity facility.

It is also now common place in CMBS 2.0 transactions, for the servicer or, if the loan has transferred to special servicing, the special servicer, to inspect the property if it becomes aware that the property has been materially damaged, left vacant, abandoned or if environmental waste has been committed. It may also carry out more frequent inspections if it is concerned as to the borrower's ability to meet its financial obligations under the loan finance documents.

11.2.6 Modifications, waivers and consent under the loan finance documents

Whilst servicers are empowered to agree to modifications, waivers and consents in connection with the loan finance documents on behalf of the lenders, they may do so only in accordance with the parameters laid down in the servicing agreement and, where applicable, the intercreditor arrangements. If the terms of the loan finance documents contemplate a particular consent or waiver, then servicers are empowered to agree to that consent or waiver provided that the servicer is satisfied (in accordance with the servicing standard) that any conditions laid down in the loan finance documents which need to be satisfied prior to such a consent or waiver being given have been met.

Servicers may also agree to consents, waivers, amendments or modifications which are not contemplated by the loan finance documents. In that regard, the servicer must be satisfied that agreeing to such matters is in accordance with the servicing standard and it must discharge its obligations to obtain the consent from or to consult with the controlling party (discussed in greater detail below). Furthermore, it is common for servicers to be prohibited from extending the maturity of a loan or changing the amount of principal, the rate of interest or prepayment fees payable on a loan, in each case without the consent of each class of noteholders. In some transactions, the servicer may be given some flexibility to extend the loan for a short period of time but never into the tail period of the CMBS (the two or three year period immediately prior to the final note maturity date) or to grant standstills for a limited period of time.

The reason for prohibiting an extension of the loan, particularly into the CMBS tail period is that the tail period allows the issuer a period of time in which to realise the loan portfolio and conclude any loan-level enforcement action (based on the projected typical timeframe for enforcement processes in any particular jurisdiction) before the notes fall due for repayment, so that the issuer can avoid defaulting on its payment obligations which would create a note event of default. As seen in the workout of legacy CMBS, obtaining noteholder consent to such loan extensions is a time-consuming and difficult process but one that the deal parties are prepared to carry out if it is the best option to maximise recoveries on the loan.

11.2.7 Enforcement

Special servicers are responsible for dealing with the enforcement and workout of specially serviced loans. Whilst a consensual workout with the borrower is preferable this frequently is not possible and so special servicers must determine how best to utilise the various rights and remedies available to the finance parties in the loan finance documentation, particularly the security, in order to maximise recoveries to the issuer. It is within the special servicer's discretion to determine in accordance with the servicing standard the best strategy to achieve this, but often the special servicer is required to notify the various parties it represents before commencing with any enforcement action and provide such parties with periodic progress updates.

Despite special servicers being granted powers of attorney to enable them to carry out enforcement action in the name of the security holders, local law requirements and practices may not recognise such powers of attorney and so special servicers may need to obtain local law compliant powers of attorney or, in some cases require the security holder itself to execute documentation in order to facilitate an enforcement procedure. When it comes to the manner of enforcement, special servicers will generally want to avoid enforcing the mortgage over the real estate to exercise the power of sale contained therein. In some jurisdictions, such as Germany, this is by far the most expensive, time-consuming route available and can take control of the process away from the special servicer. Thus, taking enforcement action of this kind is often the last resort where all other options are not viable.

It is worth noting that some enforcement procedures require the loan debt to have been demanded before the procedure can commence. The obvious risk of demanding payment from the borrower is that the directors or managers of the borrower may then be duty bound to file the borrower for insolvency. This is, almost without exception, considered unhelpful for secured creditors—not only does it add an additional level of complexity, but it will inevitably increase costs, reduce recoveries and cause significant delays, as well as risking the loss of the finance parties control over the general workout strategy of the borrower. Many legacy CMBS deals also prohibited servicers (and issuers) from granting indemnities. This created an issue on enforcement as its fairly common practice for insolvency practitioners to require indemnities from the secured creditor as part of their appointment. CMBS 2.0 deals are, as a result, often documented to permit such indemnities to be given.

One significant restriction to the workout of loans in legacy CMBS deals is that the servicing agreements typically prohibited special servicers from selling the underlying loans. Servicers frequently received offers from third parties, as well as from the underlying borrower's affiliates, to purchase the securitised loan at a discount (commonly referred to as a discounted pay off or DPO[5]) but servicers were not able to proceed even though the DPO would have been the best outcome for the issuer. Accordingly, one of the main changes in CMBS 2.0 loan servicing is the introduction of an express right for special servicers to sell defaulted loans, instead of enforcing their security, if they determine that a sale is the most appropriate course of action consistent with the servicing standard. The special servicer's right is likely to be subject to other conditions, such as the sale price must be the best price achievable in the market at the time and the sale price must be unconditionally paid in full at the time of sale (thus there can be no deferred consideration component to the sale price). Further, special servicers are often restricted to only selling the loan to third party purchasers and thus can not sell to the underlying borrower's affiliates or sponsors.

Another criticism of legacy CMBS deals is that there was a disconnect between servicers' obligations to maximise recoveries and the obligation of the issuer to repay the notes at the final note maturity date. Legacy CMBS documentation did not permit or contemplate that noteholders would want an open dialogue with special servicers to input on the approach to realise the loan portfolio before the legal maturity of the notes. In addition, when legacy CMBS deals were originally documented they were done so on the general assumption that the issuer security trustee would enforce its security package over the issuer and effectively direct the servicer to liquidate the issuer's asset. However, in practice this has not happened and ultimately such course of action is viewed as not being the best course of action to maximise recoveries.

Accordingly, CMBS 2.0 deals have introduced the concept of a note maturity plan, the consequence of which ultimately is to put the noteholders in the driving seat to determine the course of action the special servicer should take if the underlying loans remain outstanding in the run up to the legal maturity of the notes. Under CMBS 2.0, if any part of a loan remains outstanding six months prior to the final note maturity date and the special servicer is of the opinion that it is unlikely all recoveries on the loans (whether through enforcement or otherwise) will be realised before the final note maturity date, then the special servicer is required to deliver a note maturity plan to the issuer and, ultimately, to the noteholders setting out the special servicer's proposals for realising those loans. The issuer is required to then convene a noteholder meeting so that the note maturity plan can be discussed between the issuer, the noteholders (of all classes) and the special servicer. The special servicer is then obliged after that meeting to revise the note maturity plan to address the views of the note-

[5] See Ch.5.

holders and to deliver that final note maturity plan to the issuer and, ultimately, the noteholders. The issuer is then required to convene a further noteholder meeting, but of the most senior class of noteholders only, at which the most senior class of noteholders will select their preferred proposal and after that meeting the special servicer is required, notwithstanding any requirements of the servicing standard, to implement that proposal. If no proposal is approved by the most senior class of noteholders then the issuer security trustee shall be deemed authorised to appoint a receiver over all the assets secured in its favour.

As a further tool to facilitate dialogue between the servicer/special servicer and noteholders, the servicer/special servicer's ability to convene noteholder meetings in CMBS 2.0 deals is not limited to meetings relating to the note maturity plan. The servicer/special servicer now has the general power to require the issuer to call noteholder meetings for such purposes as it sees fit to put matters to the noteholders or a certain class thereof for their consideration.

11.2.8 Controlling party consent and consultation rights

Despite the broad discretion of servicers under the servicing agreement, key amendments to the terms of the underlying loans and enforcing the security are often subject to consent rights in favour of the controlling party.

Where the whole loan is held in a CMBS, the controlling party will be the controlling class, which is usually defined as the most junior class of notes which, based on the aggregate outstanding principal amount of the issuer's loan portfolio, would see more than 25% of the principal balance of that class of notes repaid. If the loan is tranched, then the controlling party will be the most junior lender in respect of which a CVE is not continuing (typically defined by reference to expected recoveries, based on the most recent valuation of the underlying real estate, being low enough that the junior lender would expect to recover less than 25% of its principal loan commitment), before passing to the next most junior lender, or, if there is no other junior lender, then the senior lender. Where the senior lender is a CMBS issuer, then the controlling party will be the controlling class.

The documentation surrounding consent and consultation rights is often complicated and requires servicers to fully analyse the terms of the servicing agreement and, where the loan is tranched, the intercreditor agreement, to understand what matters require the servicer to seek controlling party involvement, and whether that involvement is consent or consultation.[6]

At the securitisation level, the controlling class will need to appoint an operating adviser in order for its consent and consultation rights to apply. If

[6] See further Chs 5, 6 and 7.

a controlling class has appointed an operating adviser it must notify the servicer, special servicer, note trustee and issuer security trustee. Most servicing agreements typically state that if the controlling class fail to do this the servicer/special servicer may proceed on the basis that no operating adviser has been appointed. Some servicing agreements (particularly in legacy CMBS) are silent on this point. In those instances, a prudent servicer may wish to contact the market, requesting any operating advisor identifies itself to the servicer.

Since the operating adviser (OA) is a single entity, it enables the servicer to communicate and discharge its consent/consultation duties more efficiently than if it had to deal with numerous noteholders within the controlling class. Whilst all deals differ to varying degrees, the consent of the OA will often be required prior to consenting to a loan extension (unless such extension is contemplated by the original terms of the facility agreement), varying the timing or amount of payments of interest or principal, deferring payments of interest for a significant period of time, varying other material provisions of the finance documents, taking enforcement action, releasing a borrower from its obligations and releasing security where it is not contemplated by the loan finance documents (e.g. where the loan is not repaid in full at maturity or where an asset sale doesn't meet the specified allocated loan amount (ALA) requirements).

Servicing agreements set out in detail the process for obtaining OA consent and often require the servicer to give 5 to 10 business days prior notification of its intended course of action and the OA is entitled to raise objection and propose an alternative course of action within that timeframe. If the OA does not respond within the specified timeframe then it is deemed to have given its consent and the servicer may proceed with its intended course of action. If the OA does respond within such period, then there is typically a period of continuing dialogue between the servicer and the OA, usually in the region of 15 to 30 days. After which, if no agreement is reached between the servicer and the OA, the servicer can proceed with whatever course of action it determined in accordance with the servicing standard.

Notwithstanding the OA consent procedure set out above, the servicer will also benefit from what is known as the servicing standard override—this entitles the servicer to take immediate action or to liaise with the OA for a shorter period of time that the servicing agreement otherwise requires, if to do otherwise would be contrary to the servicing standard. Furthermore, it also entitles the servicer to refuse to take any action if to take that action would violate the servicing standard. The servicer standard override can, therefore, be an important tool for servicers to ensure it discharges its primary duty of servicing the underlying loan and, moreover, it protects it against directions from an OA which may, by the very nature of the OA acting solely in the interests of only the controlling class, not be in the best interests of all noteholders.

In the case of A/B loans, the junior lender's consent rights whilst it is the controlling party are typically the same as those of the controlling class, although in some deals they can be more encompassing and, in some instances in legacy CMBS deals, the junior lender also has certain entrenched rights which it retained even after a CVE. In addition, the junior lender often had in legacy deals consultation rights with respect to any matter which the servicer considers to be a ''significant action'' with respect to a loan or its security.[7]

Some noteholders, however, view appointing an OA as a double-edged sword—opening oneself up for challenge from other noteholders within the controlling class for which that OA represents. As such, an OA is more likely to be appointed where one particular organisation owns the entire controlling class. Furthermore, if a noteholder appoints itself as OA, then this can limit the noteholder from trading its notes. This is because the OA, when exercising its consent and consultation rights, will become privy to price-sensitive information which may affect the price of its notes. The MAD (and the rules of the various European jurisdictions implemented MAD into national legislature) create an offense for those trading securities based on price-sensitive information, known as insider dealing.[8] Accordingly, noteholders may not wish to appoint themselves as an OA because they will not want to have their general ability to trade their notes fettered, even at the cost of losing a degree of control over the proposed actions of the servicer.

11.2.9 Special serviced loans and corrected loans

CRE loans will be serviced by the primary servicer unless and until any one of a number of events occurs with respect to the loan (known as servicing transfer events). Once a servicing transfer event occurs, the special servicer will take over responsibility for servicing that loan and addressing the particular matter which caused the loan to switch to special servicing.

The list of servicing transfer events varies from deal to deal, but typically CMBS 2.0 servicing transfer events include: (i) failure to repay the loan on its maturity; (ii) any other payment default which is more than 30 days past due; (iii) any borrower being subject to an insolvency or insolvency proceeding based loan event of default; (iv) any cross default or creditor process loan event of default; or (v) any other loan event of default occurs or, in the reasonable opinion of the servicer, is imminent, which in either case is not likely to be cured within 21 days but is likely to have a material adverse effect on the interests of the lender.

In the case of tranched loans, the intercreditor agreement will often state that a servicing transfer event will not occur for so long as the junior lender

7 Junior lender consent and consultation rights are discussed in more detail in Ch.7.
8 See Ch.13 of the 1st edn.

is exercising (or is within the period to exercise) its cure rights in respect of the default which has caused a servicing transfer event. However, it will not be possible to stop a servicing transfer event arising following a maturity breach or an insolvency based breach.

Despite the transfer to special servicing, as stated above, the primary servicer will remain responsible for collecting and monitoring debt service, monitoring insurance compliance as well as continuing to perform its various CMBS reporting obligations. The primary servicer will continue to receive its fee for performing these duties. However, primary servicers, have in the context of legacy CMBS deals, often found themselves in a position where the loan has not yet switched to special servicing (because although there is a loan event of default a servicing transfer event has not yet arisen) but they are nonetheless carrying out a greater level of service than was originally contemplated. As discussed below, the fee provisions in CMBS 2.0 servicing agreements goes some way to address this by permitting the primary servicer to charge additional fees in certain circumstances (although these are only recoverable from the borrower).

It is possible under the servicing agreement for a loan in special servicing to ''flip'' back to primary servicing if it has become a corrected loan. Typically, a loan will become a corrected loan if, in the case of payment or other monetary default, the default has discontinued for two consecutive interest periods and for any other servicing transfer event, the event which caused the transfer to special servicing event has ceased to exist.

11.2.10 Fees

Servicing fees in CMBS 2.0 are split into five components—the primary servicing fee; the servicer modification fee (which was not a feature of legacy CMBS); the special servicing fee; the workout fee; and the liquidation fee. In addition, servicers are entitled to recover out-of-pocket cost and expenses reasonably incurred in the performance of their duties.

Primary servicers are entitled to receive the primary servicing fee, which is a low basis point per annum fee calculated against the outstanding balance of all loans and payable on each note payment date. The fee rate is designed to reflect the fairly straightforward cash management and administrative nature of their role.

As indicated above and in the previous two Chapters, in practice primary servicers have often found themselves in circumstances where loans are in, or heading towards, a distressed position but have not yet been transferred to special servicing, and are carrying out special servicing functions without being appropriatly remunerated for such services. In particular, the work involved in deciding whether or not to agree to consents, waivers and modifications is often time-consuming and will often involve the preparation of internal credit papers, credit committee approval, detailed analysis of cashflows and projections. Such matters have, in legacy deals, often been dealt with in primary servicing with a view to restructuring a loan before it goes into default. Given the relatively low basis point fee which primary servicers are entitled, primary servicers will want to charge the borrower a fee for agreeing to the borrower's request. Accordingly, CMBS servicing agreements permit primary servicers (but not special servicers) charging such a fee (referred to as the servicer modification fee), provided the fee is consistent with the servicing standard and it can be recovered from the borrowers without resulting in any shortfall in current interest or any other amounts due under the finance documents. The servicer modification fee can be structured as an ongoing or periodic fee but the rate per annum can not exceed the special servicing fee rate.

Special servicers are entitled to a special servicing fee, which is a higher basis point per annum fee than the primary servicing fee and also calculated against the outstanding balance of all specially serviced loans and payable on each note payment date. This higher fee is designed to reflect the additional work and expertise required to properly service loans in special servicing. Special servicers are also entitled to two performance based fees: the workout fee and the liquidation fee. The workout fee arises where a specially serviced loan becomes a corrected loan and for so long as it remains a corrected loan. The workout fee rate is typically higher than the special servicing fee rate and calculated against all principal and interest received on a corrected loan and is intended to reward the special servicer for converting a non-performing loan into a performing loan. The liquidation fee incentivises the special servicer to maximise recoveries in the event of liquidation of a specially serviced loan or its underlying property. The quantum of the liquidation fees is, like the workout fee, typically higher than the special servicing fee but is calculated against the net liquidation proceeds received and is typically paid to the special servicer on the note payment date following receipt of such proceeds. In legacy CMBS, the liquidation fee was often stated as only being based on a liquidation of the underlying real estate following the enforcement of the security. The concern from the special servicer's perspective therefore is that if they carried out any form of consensual workout of the loan which still resulted in liquidation proceeds they would not receive a liquidation fee despite their hard work in conducting that consensual workout. Accordingly, CMBS 2.0 deals make it clear that the liquidation fee is due if the liquidation proceeds arise following the enforcement of security, the sale of a loan to a third party (but not a resale back to any originator) or through a consensual or other workout of the loan.

The securitisation level documentation architecture is usually structured such that the payment of the liquidation fee to the special servicer reduces principal recoveries to the creditors/noteholders due to the fee being paid out of funds that would otherwise be available for distribution to the creditors/noteholders. Notwithstanding how the securitisation documentation contemplates the liquidation fee being paid, there have been a number of examples of the special servicer, on behalf of the issuer, charging the liquidation fee to the borrower under the fees/costs indemnity and expenses provisions in the underlying finance documents. This can avoid a shortfall being incurred by the creditors/noteholders, but only when the net liquidation proceeds are sufficient to discharge in full all loan liabilities and cover the liquidation fee. If such proceeds are not sufficient then charging the liquidation fee to the borrower may, so far as the creditors/noteholders are concerned, have the same net effect as paying the liquidation fee at the securitisation level. Further complexity can arise if the underlying loan is tranched—in such circumstances careful consideration should be given to the terms of the intercreditor documentation as to how servicer fees are expected to be recovered from the issuer and/or the junior lender, and if charging the liquidation fee to the borrower would contradict such terms.

In legacy CMBS, the fee rates for each of the fees discussed above was fairly standardised across all deals. However, this has changed in CMBS 2.0 with fees varying quite considerably to account for the size and complexity of the deal. This change in approach reflects some market concerns under legacy deals that, because the fee percentages were effectively the same for all deals, it meant that on deals that were larger but less complex these fees represented somewhat of a windfall payment to servicers doing little work whilst on smaller more complex deals the servicer/special servicer was not being appropriately remunerated even though it may be engaged in a significant amount of work.

11.2.11 Liability, termination and replacement of servicers

The liability that loan servicers owe to their appointers is typically limited to losses and liabilities incurred as a result of the servicer's negligence, fraud or wilful misconduct. Of fundamental importance to servicers, the servicing agreement should also state that servicers are not responsible or liable for the loan portfolios performance or any shortfall in ultimate recoveries, nor the payment obligations of the issuer under the notes. Moreover, servicers are also indemnified for any losses or claims they may incur in the discharge of their duties.

Servicers who diligently discharge their obligations should remain appointed as servicer for the life of the loans, with their appointment automatically terminating when the last of the recoveries on the last loan in the CMBS portfolio has been received. However, a fundamental control right for the issuer security trustee is the right to terminate the servicer if certain material events occur with respect to the servicer. Whilst varying from deal to deal, the right to terminate the servicer will usually arise where: (i) the servicer has failed to remit funds to the issuer when due; (ii) the servicer has breached any of its other material obligations; (iii) the servicer is insolvent or any insolvency or similar proceedings have been taken or commenced; (iv) the servicer ceases to carry on its business or is unable to discharge its duties; and (v) the servicer pays all or any part of its remuneration to a noteholder. Whilst a matter of negotiation, the servicer will usually benefit from grace periods for certain of these events allowing it time to remedy the breach and avoid the issuer security trustee being able to terminate its appointment. As mentioned earlier in this Chapter, in CMBS 2.0 the servicer is often the same entity as the loan facility agent and loan security trustee and thus if the servicer terminates its appointment as loan facility agent or loan security trustee that is also usually a termination event in the servicing agreement. Conversely, if the servicer is terminated in its role as servicer, it is usually required to resign as loan facility agent and loan security trustee.

Whilst neither the issuer nor the issuer security trustee have a right to terminate the servicer without cause, the controlling class (through its OA) typically has the discretionary right to terminate the special servicer at any time and appoint a replacement special servicer of its choosing, provided that the replacement special servicer satisfies certain conditions contained within the servicing agreement. The use of this right in legacy CMBS has been a hotly discussed topic. Initially included to provide the controlling class with a degree of control in the event that the special servicer was underperforming, there have been a number of instances where the controlling class has terminated existing special servicers and replaced them with special servicers affiliated or otherwise associated with the controlling class. This has raised concerns in the market, particularly from the more senior classes of noteholders, that the newly appointed special servicer will workout specially serviced loans or otherwise carry out its duties in a manner favourable to the interests of the controlling class, disregarding the servicing standard which it should comply with at all times. CMBS 2.0 deals sometimes also give the noteholders (as a collective whole, but the controlling class excepted) the right to terminate the servicer or the special servicer.

Another problematic feature of legacy CMBS deals was that the change in servicer often required each of the rating agencies appointed on the deal to confirm that the change in servicer did not result in a downgrade of the ratings. Some of the agencies, Moody's in particular, adopted a policy of refusing to grant such confirmations and, as a result, this meant the requirements to change the servicer could not be confirmed. This legal issue has been the subject of much debate and, in some cases, the legal position has been before the English courts.[9] To address this, whilst CMBS 2.0 will still require rating agency confirmations, the securitisation documentation will make it clear that if a rating agency doesn't respond to a request for confirmation within a time period or does respond to the effect that they are unwilling to review the change in servicer, then the requirement for such a confirmation will cease to apply.

9 *Deutsche Trustee Company Ltd v Cheyne Capital (Management) UK (LLP)* [2015] EWHC 2282 (Ch); *US Bank Trustees Ltd v Titan Europe 2007-1 (NHP) Ltd* [2014] EWHC 1189 (Ch).

11.3 Conclusion

Loan servicing is an integral function within CRE financings and, as this Chapter and the previous two Chapters have outlined, servicers are generally given broad powers and discretion in the performance of their roles, with CMBS 2.0 documentation addressing many of the loan servicing concerns that arose in legacy CMBS deals. The role of servicers is much clearer and better defined in CMBS 2.0, arming servicers with additional contractual rights and tools to help facilitate loan workouts and restructurings and, at the same time, enabling greater interaction between servicers and noteholders when necessary.

The future of loan servicing, however, remains a challenging market. Legacy CMBS deals will continue to run-off and, with it, so do the servicers running fees. With CMBS 2.0 issuance remaining patchy, unaided by general market conditions and the UK's decision to leave the EU, it is likely to remain fairly stagnant in the short to medium term. Accordingly, whilst liquidation fees and workout fees on legacy CMBS deals may, in part, supplement a drop in running fee income for the servicing community, servicers have to (and will need to continue to) expand their business offering more widely, so they are not reliant on an active CMBS market. Those with real estate experience, experienced asset management platforms and investment teams will be best placed to succeed in an ever challenging market place.