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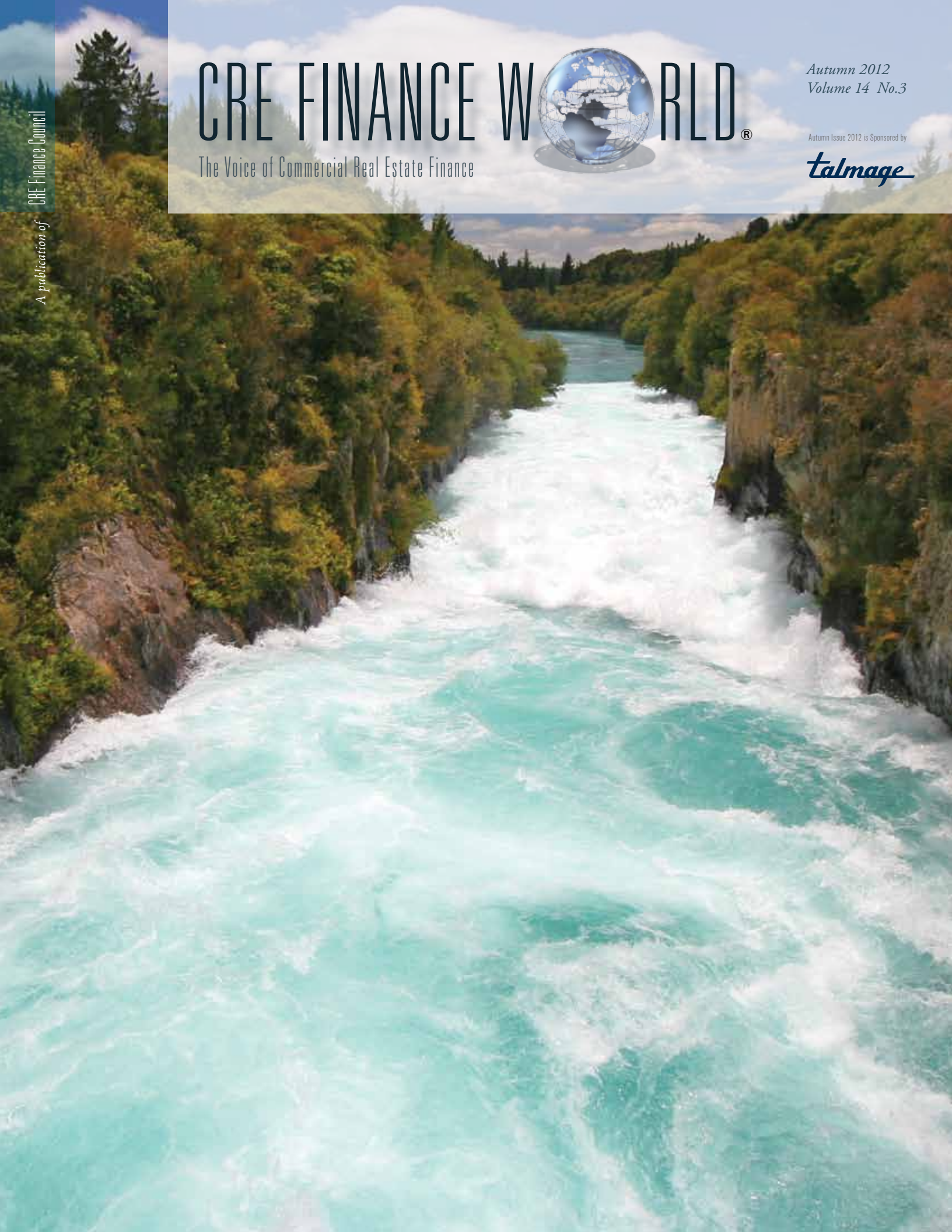

Navigating the Structured Finance Waterfall: Smooth Sailing or a Barrel Ride over the Falls?

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Everyday business language is awash in references to water — "liquid" assets, "liquidity" events, cash "flow," companies trying to "stay afloat" (perhaps because they tried to "boil the ocean") and, of course, the "waterfall." In real estate structured finance, waterfalls are the "plumbing" through which cash and control rights flow.

Most of the time, waterfalls work fine. However, in a restructuring, rocks sometimes lurk beneath the waterfall, and we discover that the plumbing — which looked great initially — connects differently than an investor thought it did or has developed a clog not even Drano® can fix. Some recent matters illustrate — and several important court cases are beginning to define — how the operative documents in structured finance transactions will be interpreted under certain circumstances; these cases,[1] in turn, are influencing the initial and secondary market investment calculi and strategies of stakeholders involved in restructuring obligations held in CMBS and CDO structures.

Complicated piping can lead to unintended, or unexpected, consequences

Even the simplest waterfall can contain upwards of a dozen steps and reference at least that many defined terms (usually more). Intended to capture virtually all circumstances that might arise during the life of a credit, these provisions occasionally fail to adequately address some common restructuring outcomes.

Recently, a special servicer embroiled in a Chapter 11 case involving a large, securitized loan was negotiating with the debtor over plan provisions which contemplated extending the loan's maturity date, payment of post-petition default interest and an increase in the post-confirmation interest rate (additional interest). The special servicer, contractually bound to maximize NPV for all certificateholders, sought to confirm how default and additional interest would flow through the waterfall. Surely, those millions of dollars would flow to the certificateholders put at risk by the default and bankruptcy, thus improving their collective NPV, right?

Well, maybe not. After reviewing the documents, it was concluded that default interest would (assuming no post-confirmation default) likely end up in a non-offered certificate class the sole purpose of which was to receive excess default interest (i.e., default interest not otherwise distributed to cover servicer advances, ordinary interest shortfalls or principal distribution shortfalls). Talk about the pipe emptying into the basement. Since the NPV calculation is identical whether additional dollars are received as default interest, ordinary interest, or a fee, negotiating a reasonable plan treatment becomes even tougher when the waterfall directs dollars towards residual classes instead of those bearing actual risk.

Worse still, the "what happens to additional interest?" answer was, at best, inconclusive. First, additional interest couldn't go to interest-bearing certificateholders as interest; their pass-through rates were either fixed, LIBOR plus a spread, or linked to a fixed mortgage rate (which could not be altered even if the underlying loan interest rate was changed pursuant to a Chapter 11 plan). Second, there was no provision which could reasonably be construed to characterize additional interest as a reserve, fee, prepayment penalty, or yield maintenance. Finally, while arguably an unscheduled payment, none of the provisions for distributing unscheduled payments captured additional interest.

While it addressed a frequent Chapter 11 outcome, i.e., the loan interest rate goes down, the plumbing failed to connect additional interest to the interest-bearing certificateholders — the parties at risk and those who should, in theory, benefit most.

The trustee will ultimately have to decide how to distribute additional interest (absent the likely impossible task of modifying the pass-through rate definitions in the trust agreement). However, if default and additional interest become part of the deal with the debtor, default interest is likely to be of little or no benefit to certificateholders generally, and additional interest could end up being paid out as a principal payment, potentially reducing certificateholder NPV, an odd result compared to how those dollars would affect a balance sheet lender's recovery.

Mezzanine lender control — water doesn't always flow straight downhill

Following a UCC foreclosure, mezzanine lenders typically obtain control by beneficially assuming ownership (stepping into the shoes) of a mortgage borrower that holds title to real estate. As a result, acquisition of mezzanine debt is frequently the entry point for distressed and event-driven investors seeking to control good real estate saddled with bad capital structures. One recent example highlights how control waterfalls in senior/mezzanine intercreditor agreements don't always flow as mezzanine lenders think they should (or wish they did).

In *U.S. Bank National Association, Trustee v. RFC CDO 2006-1 Ltd.,* involving the JW Marriott Star Pass Resort in Tucson (Star Pass), the fight concerned whether a mezz lender, via a UCC

foreclosure of its collateral (the borrower's equity interest in the property-owning entity), would have the capacity to place the property-owning entity into bankruptcy, thus blocking a foreclosure by the secured lender.

In *Star Pass*, the senior and mezzanine loans had been originated by the same bank. The mezz was economically underwater, creating the appearance that the planned bankruptcy was an attempt to use legal and/or structural leverage, rather than a true economic equity position, to gain control of the underlying asset (or to be paid to get out of the way).

Even more troubling for the senior lender was that if the mezz lender succeeded, it would foreclose on the mezz borrower and take control of the mortgage borrower without assuming the nonrecourse carveout guaranty. The typical CMBS 1.0 impediment to a mortgage borrower bankruptcy — springing guarantees which cause an otherwise nonrecourse loan to become recourse upon a bankruptcy filing — disappears when a mezz lender forecloses since there is neither the requirement, nor the means to force, a mezz lender to assume the springing guaranty.

"Control waterfalls vest servicers with significant responsibility and can instill controlling certificate holder(s) with considerable authority."

How did the court rule? In a decision similar to the New York state court ruling in the Peter Cooper Village/Stuyvesant Town case *(Bank of America, N.A. v. PSW, NYC, LLC)* (PCV), the Federal District Court in Arizona issued an injunction against the mezz's UCC foreclosure. As in *PCV*, the *Star Pass* court focused on a rock beneath the control waterfall — the widely used form of senior/mezz intercreditor agreement (used here) *requires* the mezz lender to cure defaults under the senior loan *before* exercising its UCC foreclosure rights. Had the mezz lender foreclosed without doing so (and without assuming the springing guaranty) and subsequently placed the mortgage borrower in a Chapter 11, the senior loan's special servicer and the CMBS trust would have found themselves in exactly the position they had bargained to avoid in the loan and intercreditor agreement, while fighting a debtor with little to lose and much to gain.

In *Star Pass* and *PCV*, each court — aware of the mezz lender's intention to chapter the borrower unbridled by the springing guaranty — may have determined that the ends (an economically fair result) justified the means (nuanced decisions narrowly interpreting the intercreditor bargain). Depending on the intercreditor agreement, proactive special servicing and decisions such as *PCV* and *Star Pass* now put what had been an effective mezzanine lender strategy at risk.

Synchronized swimming is harder than it looks

Control waterfalls vest servicers with significant responsibility and can instill controlling certificateholder(s) with considerable authority. Borrowers, too, have levers they can pull. When the borrower, controlling certificateholder and designated servicer involved in a securitized financing tried a coordinated dive into the restructuring water, the legal "splash" was considerable.

In a case involving The Atlantis, a $4 billion resort in The Bahamas, the controlling holder, in concert with the borrower, negotiated a debt-for-equity exchange which was to occur simultaneously with a restructuring of the mortgage loan and other borrower obligations. The borrower and controlling certificateholder wanted the servicer (appointed by the controlling certificateholder as was its right) to approve the restructuring. Other certificateholders sued, seeking a temporary restraining order on the grounds that the proposed transaction unfairly benefited the controlling certificateholder at the more senior certificateholders' expense and, further, that the servicer had breached its fiduciary duty by failing to act in the best interests of *all* certificateholders.

In *Trilogy Portfolio Company, LLC, et al. v. Brookfield Real Estate Financial Partners, LLC et al; Court of Chancery of the State of Delaware; C.A. No. 7161-VCP* (Atlantis), the court found the more senior certificateholders' argument persuasive enough to grant a TRO. Subsequently, the controlling certificateholder abandoned the proposed transaction, restructuring the loan and control of the borrower on terms that received enough certificateholder support to close.

Some key takeaways (and unanswered questions) from this case highlight the complications associated with control waterfalls and the relationships among stakeholders than can evolve in structured transactions.

- The plaintiffs alleged that due to prior negotiations between the controlling certificateholder and the borrower (before the new servicer was designated) the controlling certificateholder had become an affiliate of the borrower and was therefore prohibited from acting as the directing certificateholder. Regardless of the argument's merit (the court did not rule on that issue), holders of junior interests should be cautious with respect to the degree of interaction they can or should independently have with the borrower.

- This case also poses questions regarding the range of workout options a servicer should explore and negotiate with the borrower (the suit alleged, and the servicer contested, that little independent exploration or negotiation was done by the new servicer which allegedly was brought in to effectively rubber stamp the previously negotiated deal), and how the best interests of all certificateholders is actually determined. Is the typical maximize NPV concept enough and to what alternatives, if any, should the proposed deal be compared? As NPVs are often calculated using a loan's non-default interest rate as the discount rate (absent PSA provisions to the contrary), this question might be even more germane in today's interest rate environment.

- More generally, *Atlantis* shines a bright light on the ambiguity that exists regarding a servicer's fiduciary duty in light of the inevitable conflicts between senior and junior certificateholders. Can the kind of debt-for-equity swap attempted here (a trade often seen in corporate restructurings) ever work given the control waterfall and competing interests present in a securitized financing?

Elements of two cases (one in litigation and another which settled) have been merged to provide an example (Pipe Break Hypothetical) of what is both right and wrong with control waterfall timetables, the rights of controlling holders, and the obligations of special servicers.

In *Pipe Break Hypothetical*, the controlling holder, owner of the non-securitized Participation C note in an A/B/C structure, wanted to exercise its fair market value (FMV) purchase option of the securitized Participation A and B interests, and sought to do so according to the timetable specified in the co-lender agreement. So far, so good. The price the Participation C holder proposed to pay for Participation A and B was less than par. While not the economic result the Participation A and B certificateholders anticipated when the loan was originated, the plumbing nevertheless still appeared to be working as designed. So why the lawsuit?

While the Participation C holder was pursuing its FMV option via one pipe, a control appraisal event was moving through another. The control appraisal event, which would transfer control to certain senior Participation A classes was proceeding — but had not yet been completed — according to a separate timetable. It's not hard to guess whose pipe was shorter…the Participation C holder's.

In addition to questioning whether the trustee and special servicer acted appropriately (and in accordance with the trust's controlling documents), the plaintiffs alleged that allowing the Participation C holder's transaction to close would wrongly deprive them of their interests in the Participation A note as well as control rights over other mortgages owned by the trust, since their ownership would be terminated (purchased) before completion of the appraisal and control shifting to them.

The trust agreement in *Pipe Break Hypothetical* required (as is common) that at least 25% of *each affected class of certificates* make a written request of the trustee in order to institute a legal proceeding in connection with the trust. The Participation C holder argued that the proposed sale of Participation A and B at a substantial loss would affect all certificate classes, and the plaintiffs (holders of some, but not all, of the classes) failed to meet the 25% threshold.

Pipe Break Hypothetical raises several issues.

- Timetable mismatches occur more frequently than one might imagine, sometimes affecting servicer tasks such as preparing, submitting and gaining controlling certificateholder consent for workout plans and/or foreclosure actions.

- Trustees and special servicers are contractually bound to observe the letter of the underlying documents — including timetables. What is a trustee or servicer's duty when presented with a proposed transaction that would not be supported at the conclusion of another, misaligned timetable? Had the control appraisal pipe been shorter than the FMV option pipe, would shifting control to senior Participation A classes before the option closed *really* be a more equitable result? One could argue that the documents are what they are, warts and all; if you didn't like what they say, perhaps you shouldn't have invested in the first place.

- What does "affected classes" really mean? Are affected classes only those negatively affected, or do they also include those that are positively affected? Assuming, for argument's sake, it's the former, are affected classes only those which will suffer a *realized loss* (as defined in the trust documents) or do they also include those who will suffer an *economic loss* as a result of lowered market value and/or subordination levels?

Contractually, trustees, servicers and administrative agents are service providers. Do they have the legal standing and authority to make these kinds nuanced judgment calls in the absence of litigation?

Finally, from the special servicer's perspective (one influenced in part by the fact many servicer affiliates own junior interests like Participation C), to what extent is an FMV option a valuable

asset or simply an invitation to litigation? And what steps should a prudent holder of a FMV Option undertake to minimize the risk of suit and an adverse ruling?

Conclusion

Clearly, the plumbing of the typical structured finance waterfall contains numerous twists, turns and potential traps for the unwary. Given recent federal and state court litigation (including bankruptcy court litigation — perhaps the biggest boulder beneath the waterfall), existing and prospective stakeholders in structured finance credits would be well served by taking a very hard look at the pipes *before* they turn on the faucet.

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Views expressed herein are those of the author and do not necessarily reflect the views of FTI Consulting, Inc. and its other professionals.

1 While FTI has played a significant role in several of the referenced cases, everything discussed is from the public record. Out-of-court or pending matters discussed have been generalized to maintain confidentiality.