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The Return of Securitized Lending: Freddie Mac Launches CMBS Loan Product*

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I. INTRODUCTION

Over most of the past decade, the commercial mortgage-backed securities ("CMBS") market has been a major source of liquidity for commercial real estate. At the peak of the market in 2007, $230 billion of CMBS were issued. In contrast, only $12 billion of CMBS were issued in 2008. Many real estate observers believe that the CMBS market must be resurrected in order to encourage banks to resume lending in any significant way.

This summer, Federal Home Loan Mortgage Corporation ("Freddie Mac") securitized approximately $1.1 billion in multifamily mortgage loans originated through Freddie Mac's Capital Markets Execution ("CME") product, which was launched last year.[1] The securities are technically known as the Series K-003 Structured Pass-Through Certificates, or K Certificates, and Freddie Mac guarantees the most senior tranches, the safest part of the deal for investors, equal to 80% of the issue.

Previously, Freddie Mac purchased multifamily loans primarily to hold in its mortgage-related investments portfolio. This summer's Freddie Mac offering was momentous because it marked the first time in nearly a year, since the collapse of Lehman Brothers and the beginning of the credit crisis, that the market had seen any new CMBS issue of this type.

Freddie Mac's offering represents a new way of providing liquidity and stability to the national multifamily housing market, by relying less on Freddie Mac's balance sheet, and thereby making more capital available to Freddie Mac for lending.[2] Investor response to the offering was reportedly strong, and Freddie Mac anticipates many future multifamily securitizations on a quarterly basis. Because of Freddie Mac's access to the capital markets, this CME product is uniquely positioned. It offers superior economics to those of much of its competition, and even Freddie Mac's own portfolio loan products, including considerably lower, fixed rates and often higher loan amounts to borrowers who are debt service constrained. This CME product undoubtedly will become a primary source of multifamily capital, and may even become the benchmark product for Freddie Mac multifamily loans.

With any CMBS loan, there is a trade-off for the exceptional economics it offers, namely less flexibility and more legal requirements than with a portfolio loan. The same is true for the CME product, but to a much lesser extent. With features unique to CMBS loans and legal requirements that are more benevolent than those of many past CMBS lenders, the CME product will appeal to many multifamily borrowers.

II. SECURITIZATION GENERALLY

The discussion below compares the legal requirements of the CME product to those for a traditional Freddie Mac portfolio loan. But before making that comparison, it may be helpful to outline the basic structure of commercial mortgage loan securitizations. It is this structure that drives the legal requirements for any CMBS loan, including those originated for the CME product.

A portfolio loan, such as a loan originated by a bank or life insurance company, may be retained in the lender's portfolio throughout the life of the loan,

1. See freddiemac.com/news/archives/mbs/2009/20090526_seriesk.html for more information.

2. This is consistent with the federal mandate imposed in connection with the federal conservatorship of Freddie Mac and Fannie Mae, which began in September, 2008. The Federal Housing Finance Agency (FHFA) currently serves as both the regulator and conservator of these enterprises.

or the originating lender may sell the whole loan to another lender, or sell to one or more other lenders undivided fractional participation interests in the loan. In the case of a Freddie Mac portfolio loan, the originating lender sells the whole loan to and typically services the loan on behalf of Freddie Mac, and is known in Freddie Mac parlance as the "Seller/Servicer."

In contrast, a CMBS loan, including a CME loan, is typically sold with other, similar loans to a special purpose entity, known as a depositor, who then deposits the loans into a trust known as a real estate mortgage investment conduit ("REMIC"). The trust then sells rated debt securities, backed by the mortgage loans, to investors. Underwriters and rating agencies arrange for the securities to be issued in different classes, called tranches, and each tranche is given a rating by the rating agencies. The different tranches reflect varying levels of risk, and correspondingly varying levels of yield, term to maturity, priority in payment among tranches, and other characteristics.

III. COMPARISON OF REQUIREMENTS

With this background, let us now compare the legal requirements for Freddie Mac's CME product to those for its portfolio counterpart.

A. Eligible Borrowers

For a Freddie Mac portfolio loan, the borrower must be a single asset entity, which means the borrower cannot (a) own real or personal property other than the mortgaged property and personal property related to the operation and maintenance of the mortgaged property; (b) operate any business other than the management and operation of the mortgaged property; or (c) maintain its assets in a way that makes them difficult to segregate and identify. That requirement provides some protection for the lender, because the borrower should not encounter financial difficulties as a result of problems with properties other than the mortgaged property, and even if the borrower files for protection under the United States Bankruptcy Code, the borrower is unlikely to be able to confirm a plan of reorganization that the lender does not approve.

For a CME loan, the borrower typically must be a special purpose entity ("SPE") that is bankruptcy-remote.[3] A SPE is an entity, formed concurrently with or immediately prior to the mortgage loan closing, that is unlikely to become insolvent as a result of its own activities and that is adequately insulated from the consequences of any related party's insolvency. Both the documents governing the formation and operation of the SPE, and the mortgage loan documents, must contain certain bankruptcy-remote covenants. These covenants generally include restrictions intended to: (a) limit or eliminate the ability of a SPE to incur liabilities other than the mortgage loan; (b) insulate the SPE from liabilities of affiliates and third parties (*e.g.*, separateness covenants); (c) protect the SPE from dissolution risk (*e.g.*, prohibitions on liquidation, consolidation and merger, and the requirement of a SPE equity owner – a second tier SPE in the ownership chain); and (d) limit a solvent SPE from filing a bankruptcy petition (*e.g.*, by requiring an independent director/manager whose vote is required prior to filing bankruptcy).[4] Thus, the requirement of a SPE borrower provides greater protection to the lender against the risk of a bankruptcy petition than the requirement of merely a single asset entity.[5]

Where the transfer of the mortgaged property to a newly-formed SPE will result in unfavorable mortgage, recording, transfer, or capital gains tax consequences, Freddie Mac may permit the existing entity to be "recycled" and used as an acceptable SPE, provided the entity makes certain representations regarding its formation, history, and current status.

3. Freddie Mac, in its discretion, may approve loans of less than $5 million in certain geographical areas, to a single asset entity that is not a SPE.

4. An "independent director/manager" means a natural person who is not, at the time of initial appointment as a director or manager or at any time while serving as a director or manager of the borrower or any SPE equity owner, and who has not been, at any time during the five (5) years preceding such initial appointment: (a) a stockholder, director (with the exception of serving as an independent director/manager of the borrower or any SPE equity owner), officer, trustee, employee, partner, member, attorney or counsel of the borrower or any SPE equity owner, or any affiliate of either of them; (b) a creditor, customer, supplier, or other person who derives any of its purchases or revenues from its activities with the borrower or any SPE equity owner or any affiliate of either of them; (c) a person controlling or under common control with any person excluded from serving as independent director/manager under (a) or (b); or (d) a member of the immediate family by blood or marriage of any person excluded from serving as independent director/manager under (a) or (b).

5. Pursuant to the United States Bankruptcy Code, the filing of a bankruptcy petition automatically stays all creditors from exercising rights to collect debts and realize on pledged collateral, and the duration of the stay is difficult to estimate. Under certain circumstances, a bankruptcy court may permit a debtor to use pledged collateral to aid in the debtor's reorganization, or to secure new debt with a lien prior to the lien of the existing secured creditors. A secured creditor in possession of its collateral may be required to return possession of the collateral to the debtor or trustee in bankruptcy. Even more, under equitable provisions of the Bankruptcy Code, a court has the power to "substantively consolidate" ostensibly separate but related entities, treating assets and liabilities of the entities as if they belonged to one, enabling creditors of each formerly separate estate to reach assets of the consolidated estate. Ultimately, this could cause holders of the CMBS to experience delays in receiving payment, and even receiving less than the full value of their collateral.

Not all types of entities are acceptable SPE borrowers. The following are permitted by the Freddie Mac CME program.

Corporation: For loans of $50 million and more, it may be required to have at least one independent director.

Limited partnership: For loans of $25 million and more, all general partners must be a SPE corporation or a SPE Delaware limited liability company ("LLC"). For loans of $50 million and more, the general partner may be required to have the equivalent of one independent director/manager.

Limited liability company with multiple members: For loans of $25 million and more, the managing member must be a SPE corporation or SPE Delaware LLC. For loans of $50 million and more, the borrower and/or the managing member may be required to have at least one independent director/manager.

Limited liability company with single member: Regardless of loan size, it must be (a) formed in Delaware; and (b) have either (i) one "springing member" that is a SPE corporation, the stock in which is wholly-owned by the sole member of the borrower, or (ii) two springing members who are natural persons. The springing member mechanism ensures that, in the event the non-SPE member ceases to be a member of the LLC, by death or other dissolution, the springing member automatically becomes a member without further act, vote, or approval of any person, so the business of the LLC will continue without dissolution. For loans of $50 million and more, the SPE Delaware LLC may be required to have at least one independent director/manager.

B. Legal Opinions

For a Freddie Mac portfolio loan, an opinion is required of the borrower's counsel, and the guarantor's counsel if the guarantor is an entity, regarding the organization of the borrower and the guarantor, and the authorization, execution, and delivery of the loan documents. An opinion on the enforceability of loan documents may also be required in certain situations.

For a CME loan, both the standard portfolio opinions and an enforceability opinion are always required. If the SPE is a Delaware single member limited liability company, Delaware counsel must opine on the formation and existence of the SPE and the enforceability of its operating agreement; if the loan is $25 million or more, Delaware counsel must further opine on who has authority to file a voluntary bankruptcy petition on behalf of the SPE and that Delaware law, not federal law, would govern the same. For any loan that is $25 million or more, a non-consolidation opinion will be required.[6]

C. Loan Covenants and Loan Documents Generally

In contrast to the relative flexibility with its portfolio loan documents, Freddie Mac requires more document uniformity with its CME product to facilitate the cost-effective sale and securitization of the loan. Borrowers also should expect stricter and more frequent requirements for reporting of various financial and project performance for CME loans, and heightened scrutiny of transfers of ownership interests given the importance of the SPE structure. Failure to comply with these requirements will result in full recourse liability under otherwise non-recourse loan documents.

Because a SPE borrower has no assets other than the mortgaged property, CMBS lenders generally require escrows for immediate repairs, reserves for long-term capital replacements, and impounds for taxes and insurance premiums. The same is true for the CME product.

Unlike other CMBS loans, the CME product contemplates the possibility of future supplemental financing through Freddie Mac's portfolio loan product. This is an appealing feature to borrowers, and rare in the CMBS world. The combined loan to value ratio of the mortgaged property after such supplemental financing cannot exceed that established by Freddie Mac at the time of closing the first mortgage loan.

D. Loan Modifications and Servicing

For a Freddie Mac portfolio loan, the Seller/Servicer services the loan in accordance with the Freddie Mac Multifamily Seller/Servicer Guide (the "Guide"). Based in part on narratives and recommendations from the Seller/Servicer, Freddie Mac will determine what loan modifications are acceptable, based on its own risk tolerance and internal guidelines. In some situations, the Seller/Servicer has authority, delegated by Freddie Mac, to make those decisions.

The Seller/Servicer also services a CME loan in accordance with the Guide, as amended and supplemented

6. Generally, a non-consolidation opinion states that if any equity owner group or group of affiliated equity owners (or group of family members) who own more than 49% of the equity in the SPE were to become insolvent, the assets and liabilities of the SPE would not be substantively consolidated with that of the equity owner or group of affiliated equity owners (or group of family members).

by the Capital Markets Execution Addendum, until the loan is securitized. Once securitized, Freddie Mac ceases to own the applicable loan, and servicing is transferred to a master servicer. A pooling and servicing agreement ("PSA") establishes the management structure and the "servicing standard" for the pool of CME loans. Generally, the master servicer is responsible for servicing performing loans in the pool, and may delegate by contract certain functions to a sub-servicer; the special servicer deals with loans in default or otherwise at risk; the trustee distributes payments to holders of the securities; and the custodian holds and safeguards all original loan documents.

As guarantor of the senior tranches, pursuant to the PSA, Freddie Mac must approve the sub-servicer. It is anticipated that the lender who originated the CME loans in the pool – *i.e.*, the Seller/Servicer, will be the sub-servicer, provided that it is rated. As it did for Freddie Mac before securitization, the Seller/Servicer will prepare narratives and recommendations, now to the master or special servicer, whose approval is required for certain important servicing matters, such as whether to foreclose a mortgage in the pool or to consent to modifying a loan.

Servicing of a CMBS loan is further restricted by rules governing REMICs. A REMIC trust is treated as a pass-through entity for income tax purposes under the Internal Revenue Code, and, to maintain this favorable tax treatment, the trust must satisfy certain rules. Generally, (a) the trust must consist of a static pool of qualified mortgage loans; (b) each mortgage loan must be contributed to the trust within three (3) months after the trust's start-up date; (c) no loan substitutions may occur; and (d) no significant modifications may occur.

Modifications that are not considered "significant," and that therefore will not disqualify a trust as a REMIC, include: (a) changes in the maturity date occasioned by default (although the length of any extension is limited); (b) loan assumption by a transferee of similar credit quality to the transferor; (c) waiver of due-on-sale or due-on-encumbrance clauses (*e.g.*, for easements that do not have a material adverse impact on value, use, or operation of the mortgaged property); (d) interest rate conversion pursuant to the loan documents; (e) modifications contemplated by the loan documents; and (f) most events occasioned by default or reasonably foreseeable default (to encourage proactive handling of troubled loans).

Pursuant to the PSA, neither the master servicer, the special servicer, nor the trustee may take any action or fail to take any action that, under the REMIC rules, would cause the REMIC trust to fail to qualify as a REMIC or result in the imposition of a tax upon the REMIC trust. To confirm this, the master servicer or special servicer may require a legal opinion from its counsel before taking or refraining from certain actions with respect to a mortgage loan in the pool.

E. Prepayment of Loan

For a Freddie Mac fixed-rate portfolio loan, a borrower may prepay its loan at any time. Only full prepayment is permitted, and the prepayment premium is equal first to the greater of yield maintenance or one percent (1%) of the unpaid principal balance, then to one percent (1%) of the unpaid principal balance, and finally the last three (3) months of the loan term are open to prepayment without premium.

For a CME loan, if the loan is never securitized or securitized more than one (1) year after origination, a prepayment premium based first on yield maintenance applies, followed by one percent (1%) of the unpaid principal balance. If it is securitized within one (1) year after origination, yield maintenance applies before securitization, followed by a two (2) year lock-out, then followed by a requirement of defeasance, and finally followed by no premium or defeasance requirement during the last three (3) months of the scheduled term of the loan.[7]

IV. CONCLUSION

It has become increasingly important to understand the legal issues involved in securing financing in the current economic climate. In particular, multifamily owners seeking financing should compare the economic advantages and legal requirements of the securitized and portfolio loan products offered by Freddie Mac.

7. With defeasance, real estate collateral securing a mortgage loan is released from the lien of the mortgage and replaced by government securities pledged to the trustee. The defeasance collateral must provide a revenue stream sufficient to pay, when due, each scheduled principal and interest payment on the defeased mortgage loan.