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## CHAPTER 2 IN THE HISTORY OF CMBS: COMING TO TERMS WITH THE NEW RULES

ALAN KRONOVET AND CHRIS VAN HEERDEN\*

### I. INTRODUCTION

Since the publication of the Note, *An Overview of Commercial Mortgage Backed Securitization* (“the 1997 Note”) in Volume 1 of the North Carolina Banking Institute Journal,<sup>1</sup> the securitization market has increased in its importance as a financing vehicle for a variety of asset classes. By providing liquidity to otherwise illiquid debt markets, securitization links providers of capital with those in need of capital by aligning the risk appetite of investors with the appropriate risk premium paid by borrowers.<sup>2</sup> In its opening chapter spanning roughly 25 years, commercial mortgage backed securitization (“CMBS”) has played a significant role in financing commercial real estate.<sup>3</sup> CMBS is now entering chapter 2 and its role in real estate financing is being shaped by new regulations and the collective memory of recent major market disruptions.

This article provides background information on CMBS in Part II.<sup>4</sup> Part III examines three specific market disruptions and their impact on CMBS over the last twenty years, and also reviews the structural, economic, and regulatory changes that resulted from those market

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1. Alan Kronovet, Note, *An Overview of Commercial Mortgage Backed Securitization: The Devil Is in the Details*, 1 N.C. BANKING INST. 288 (1997) (written while a law student and as a founding member of the North Carolina Banking Institute Journal).

2. Georgette Chapman Poindexter, *Impossible, Impracticable, or Just Expensive? Allocation of Expense of Ancillary Risk in the CMBS Market*, 36 J. MARSHALL L. REV. 653, 654 (2003) (“The hallmark of the CMBS market is its ability to match risk with return in pricing mortgage debt.”).

3. Commercial real estate describes income-producing assets most often consisting of retail, office, multifamily, and hotel properties.

4. See *infra* Part II.

disruptions.<sup>5</sup> Part IV discusses current market conditions with an eye towards the future, suggesting that the CMBS market faces the prospect of reduced growth as a result of regulatory constraints.<sup>6</sup> During the course of the article, some of the concerns initially raised in the 1997 Note are reviewed and evaluated.

## II. BACKGROUND ON CMBS

CMBS was the disruptive technology of real estate financing in the 1990s, transforming what had largely been a private balance sheet approach to lending by introducing an alternative source of funding tied to publicly traded securities. For borrowers, the arrival of CMBS meant greater efficiency in the lending process, more competition on pricing between lenders, the standardization of loan terms and documents, and financing terms that became untethered from lenders' balance sheet needs.

To be clear, financing real estate by issuing bonds was not original to CMBS, securitized mortgages having been preceded by property bonds of the 1920s and 1930s and industrial revenue bonds of the 1970s and 1980s. CMBS stands apart from these, however, because, by tranching property cash flow, securitizations created bonds with payment profiles that differed meaningfully from the underlying mortgages in terms of tenure and risk profile. Tradable bonds tied to commercial real estate with cash flows tailored to investor risk appetite proved a winning formula.

CMBS grew from relative obscurity in the early 1990s to become the largest capital source to commercial real estate by 2007. Although there were experiments with commercial mortgage securitization in the 1980s, it was the savings and loan crisis of the late 1980s and the subsequent liquidation of the assets of insolvent thrifts by the Resolution Trust Corporation ("RTC") starting in 1991 that moved the CMBS business to a critical mass in terms of market participation and infrastructure investments.<sup>7</sup> Large asset sales brought about investments

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5. *See infra* Part III.

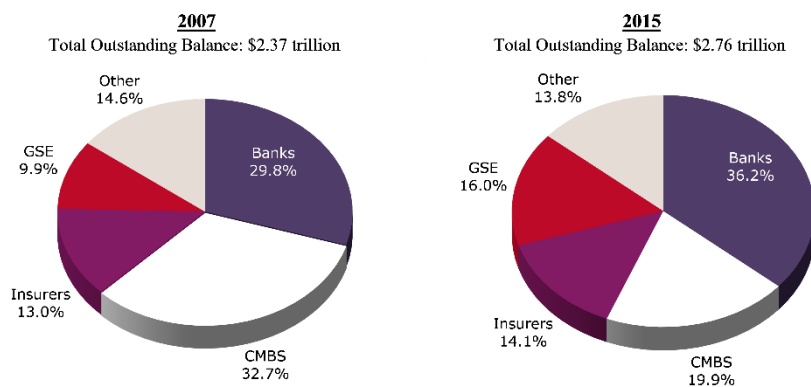
6. *See infra* Part IV.

7. In the wake of the savings and loan crisis, the RTC, established to serve as a conservator and receiver of insolvent thrifts, sold off the assets of these institutions, including commercial mortgages, through securitization. From June 1991 to December 1995, the RTC closed 27 multifamily and commercial mortgage securitizations. Putting these together with

in infrastructure to support commercial mortgages securitizations. As the decade proceeded, CMBS moved from “newcomer” to a major capital source for commercial real estate, transitioning from securitizing balance sheet loans from savings and loans, banks, and insurance companies to largely funding loans that were originated specifically for securitization. By 2007, roughly a third of the outstanding commercial mortgages in the U.S. were financed through CMBS loans (Exhibit 1).<sup>8</sup>

This long run of continued growth came to an end with the 2008 financial crisis. In the immediately following years, it became clear that leverage had climbed too high and many properties were encumbered by too much debt. The tightening of credit also proved to have an effect on real estate values. CMBS investors suffered significant ratings downgrades and losses.

### Exhibit 1: Sources of Commercial Mortgage Capital—Commercial Mortgage Debt Outstanding by Holder



Source: Federal Reserve Z.1 Financial Accounts of the United States, the FDIC, and Wells Fargo Securities, LLC.

its single family securitizations, RTC securitizations totaled over \$41 billion in assets. George Alexander and Tom Raburn, *FDIC Closes the Books on RTC Securitization Program*, CMBS WORLD (Winter 2005). Other research has also credited advances in computer technology as playing a role in securitization coming of age in the 1990s. Robert A. Brown, *Financial Reform and the Subsidization of Sophisticated Investors' Ignorance in Securitization Markets*, 7 N.Y.U. J.L. & BUS. 105, 121–22 (2010) (citing Leon T. Kendall, *Securitization: A New Era in American Finance, in A Primer on Securitization* 1, 8 (1996)).

8. In 2007, commercial mortgages outstanding measured \$2.37 trillion, of which \$776.81 billion, or 32.7%, was financed through CMBS. This estimate uses the data from Federal Reserve Statistical Release Z.1 for non-bank lender holdings and the FDIC's Quarterly Loan Performance Indicators Report to calculate bank holdings of commercial and multifamily loans excluding construction and owner-occupied properties.

The 1997 Note identified access to capital as a primary advantage of securitization.<sup>9</sup> CMBS brought capital to commercial real estate finance that may not otherwise have been available to commercial real estate owners. A corollary benefit was that borrowers were able to receive financing in secondary and tertiary markets for assets of certain types and qualities that they would not have found as abundant prior to the development of a CMBS market.<sup>10</sup> Moreover, as a result, borrowers were able to receive higher loan amounts from CMBS lenders creating more loan leverage for the property collateralizing the loan.

Access to capital proved to be a double-edged sword, however. Capital markets capital flows are sensitive to market conditions and opportunities. With CMBS becoming a key funding source, borrowers became subject to the impact of investors' other investment options. When market conditions warrant, CMBS liquidity can evaporate. The speed with which liquidity dries up creates funding issues for real estate owners looking for financing reliability.

For the 18 months running up to December 2009, no CMBS securitizations priced (Exhibit 2).<sup>11</sup> A gradual recovery followed with issuance moving steadily higher to reach \$94.6 billion in 2015. Even with this improvement, the volume of new loans extended has been less than the volume of loans paying off. As a result, the size of the CMBS sector continues to contract. At the end of the third quarter of 2015, the outstanding balance of the CMBS market measured \$550.2 billion, based on Federal Reserve data, down from \$776.8 billion in 2007.<sup>12</sup>

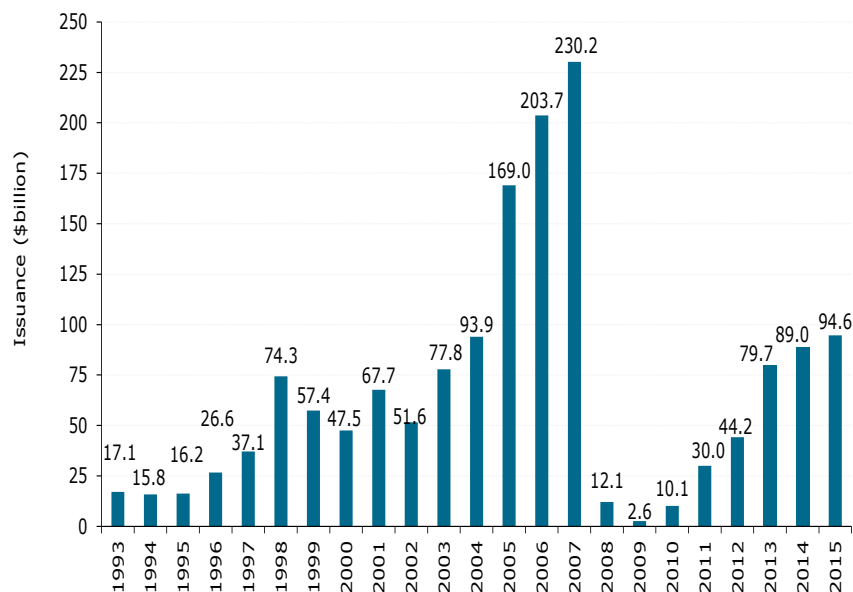
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9. Kronovet, *supra* note 1, at 289.

10. Miguel Segoviano et al., *Securitization: Lessons Learned and the Road Ahead* 6 (International Monetary Fund, Working Paper No. 13/255, 2013) ("Securitization can lower funding costs and economize on capital for financial institutions—benefits that may be passed along to businesses and consumers."); Xudong An, et al., *Value Creation through Securitization: Evidence from the CMBS Market*, 38 J. REAL EST. FIN. & ECON. 302, 303 (2009) (finding that CMBS lowers the cost of funds to borrowers).

11. Late in 2009 three single-borrower securitizations came to market, but no multi-loan conduit transactions were priced during the entire year. Adam Piore, *CMBS 2.0*, THE REAL DEAL (Jan. 1, 2011), <http://trdny.com/yBuFBw>.

12. *Federal Reserve Statistical Release Z.1, Flow of Funds Accounts of the United States, Flows and Outstandings Third Quarter 2007*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Dec. 6, 2007) (not including multifamily backed deals guaranteed by Fannie Mae and Freddie Mac), <http://www.federalreserve.gov/releases/z1/20071206/z1.pdf>; *Federal Reserve Statistical Release Z.1, Financial Accounts of the United States, Third Quarter 2015*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Dec. 10, 2015), <http://www.federalreserve.gov/releases/z1/current/z1.pdf>.

**Exhibit 2: CMBS Issuance Reached \$94.6 billion in 2015**

Source: Commercial Mortgage Alert, Intex Solutions, Inc., and Wells Fargo Securities, LLC.

Banks participate in the CMBS market in three ways: as investors, as loan originators, and as service providers. Investment in CMBS is common across banks of all sizes. Banks use CMBS as part of a diversified investment portfolio. On an industry-wide basis, CMBS made up 5.6% of bank investment portfolios at the end of the third quarter in 2015. As a separate business, a number of banks originate loans for sale into securitizations. Fewer banks—19 in total from 2010 to 2015—operate CMBS loan origination businesses, but these banks are the largest source of loans for securitization. From 2010 to 2015, banks originated 73% of the loans included in multi-loan, or conduit, CMBS transactions. Fewer banks still serve as significant service providers to CMBS, acting as master servicers, certificate administrators, or trustees.<sup>13</sup>

13. For a description of the roles of CMBS deal parties, see Stewart McQueen et al., *An Investor's Guide to the Pooling and Servicing Agreement*, DECHERT LLP 2 (June 2013) [https://www.dechert.com/An\\_Investors\\_Guide\\_to\\_The\\_Pooling\\_and\\_Servicing\\_Agreement\\_06-04-2013/](https://www.dechert.com/An_Investors_Guide_to_The_Pooling_and_Servicing_Agreement_06-04-2013/) (“CMBS transactions use a dual-servicer structure. The master servicer is generally responsible for servicing performing loans. The special servicer, on the other hand, is responsible for specially servicing loans that are subject to a servicing transfer event and

### Exhibit 3: Bank Investment Portfolio Composition by Bank Size and Investment Type

	Industry			> \$250 B			\$250B - 50B			\$50B - 10B		
Security Allocations <sup>2</sup>	3Q15	2Q15	3Q14	3Q15	2Q15	3Q14	3Q15	2Q15	3Q14	3Q15	2Q15	3Q14
<b>Total Treasury &amp; Agency</b>	<b>18.3%</b>	<b>19.0%</b>	<b>17.8%</b>	<b>17.6%</b>	<b>19.1%</b>	<b>17.0%</b>	<b>14.6%</b>	<b>13.2%</b>	<b>12.9%</b>	<b>18.8%</b>	<b>18.4%</b>	<b>18.0%</b>
Total MBS Pass-Throughs	33.4%	32.8%	31.4%	37.9%	36.1%	34.4%	28.8%	30.2%	27.6%	31.4%	32.2%	31.5%
Total CMOs	15.8%	16.0%	17.5%	12.0%	12.4%	14.2%	23.7%	23.2%	24.6%	25.6%	26.0%	27.1%
Total CMBS	5.6%	5.4%	5.2%	4.5%	4.5%	4.4%	10.0%	9.6%	8.8%	8.3%	7.9%	7.9%
<b>Total MBS</b>	<b>54.8%</b>	<b>54.2%</b>	<b>54.1%</b>	<b>54.4%</b>	<b>53.0%</b>	<b>53.0%</b>	<b>62.5%</b>	<b>63.0%</b>	<b>61.0%</b>	<b>65.2%</b>	<b>66.0%</b>	<b>66.4%</b>
<b>Total Municipals</b>	<b>10.9%</b>	<b>10.8%</b>	<b>10.3%</b>	<b>8.0%</b>	<b>7.9%</b>	<b>7.5%</b>	<b>4.4%</b>	<b>4.5%</b>	<b>4.2%</b>	<b>11.0%</b>	<b>10.7%</b>	<b>10.2%</b>
<b>Total ABS</b>	<b>3.4%</b>	<b>3.7%</b>	<b>4.5%</b>	<b>2.6%</b>	<b>2.8%</b>	<b>3.4%</b>	<b>9.3%</b>	<b>10.1%</b>	<b>12.5%</b>	<b>1.7%</b>	<b>1.7%</b>	<b>1.9%</b>
<b>Structured Fin. Products</b>	<b>2.9%</b>	<b>2.8%</b>	<b>2.7%</b>	<b>4.7%</b>	<b>4.5%</b>	<b>4.2%</b>	<b>1.0%</b>	<b>1.2%</b>	<b>1.4%</b>	<b>1.0%</b>	<b>0.9%</b>	<b>1.0%</b>
<b>Debt Securities</b>	<b>9.3%</b>	<b>9.1%</b>	<b>10.2%</b>	<b>12.5%</b>	<b>12.4%</b>	<b>14.5%</b>	<b>8.0%</b>	<b>7.8%</b>	<b>7.8%</b>	<b>2.1%</b>	<b>1.9%</b>	<b>2.1%</b>
<b>Equity Securities</b>	<b>0.3%</b>	<b>0.4%</b>	<b>0.4%</b>	<b>0.3%</b>	<b>0.3%</b>	<b>0.4%</b>	<b>0.2%</b>	<b>0.2%</b>	<b>0.2%</b>	<b>0.3%</b>	<b>0.3%</b>	<b>0.3%</b>
<b>Total Securities</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

	\$10B - 5B			\$5B - 1B			< \$1B		
Security Allocations	3Q15	2Q15	3Q14	3Q15	2Q15	3Q14	3Q15	2Q15	3Q14
<b>Total Treasury &amp; Agency</b>	<b>13.7%</b>	<b>14.4%</b>	<b>14.2%</b>	<b>22.8%</b>	<b>23.4%</b>	<b>23.2%</b>	<b>27.9%</b>	<b>28.8%</b>	<b>29.0%</b>
Total MBS Pass-Throughs	30.6%	30.4%	31.9%	25.2%	25.3%	26.0%	24.0%	24.3%	25.1%
Total CMOs	22.7%	23.3%	23.6%	17.3%	17.9%	19.4%	9.7%	9.9%	10.4%
Total CMBS	5.3%	4.9%	4.4%	4.5%	4.2%	3.6%	1.7%	1.5%	1.3%
<b>Total MBS</b>	<b>58.5%</b>	<b>58.7%</b>	<b>59.9%</b>	<b>46.9%</b>	<b>47.5%</b>	<b>49.0%</b>	<b>35.4%</b>	<b>35.7%</b>	<b>36.9%</b>
<b>Total Municipals</b>	<b>19.3%</b>	<b>19.1%</b>	<b>18.5%</b>	<b>20.4%</b>	<b>19.6%</b>	<b>18.8%</b>	<b>32.7%</b>	<b>31.7%</b>	<b>30.4%</b>
<b>Total ABS</b>	<b>1.9%</b>	<b>1.6%</b>	<b>1.4%</b>	<b>1.6%</b>	<b>1.5%</b>	<b>1.5%</b>	<b>0.4%</b>	<b>0.4%</b>	<b>0.4%</b>
<b>Structured Fin Products</b>	<b>0.8%</b>	<b>0.9%</b>	<b>0.9%</b>	<b>0.7%</b>	<b>0.6%</b>	<b>0.5%</b>	<b>0.1%</b>	<b>0.1%</b>	<b>0.1%</b>
<b>Debt Securities</b>	<b>5.2%</b>	<b>4.9%</b>	<b>4.6%</b>	<b>6.5%</b>	<b>6.3%</b>	<b>5.9%</b>	<b>2.7%</b>	<b>2.6%</b>	<b>2.6%</b>
<b>Equity Securities</b>	<b>0.4%</b>	<b>0.4%</b>	<b>0.5%</b>	<b>1.0%</b>	<b>1.1%</b>	<b>1.0%</b>	<b>0.8%</b>	<b>0.7%</b>	<b>0.7%</b>
<b>Total Securities</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

Disclaimer: 1. Portfolio indicators are not adjusted for Mergers and Acquisitions 2. Values and changes represented using end basis  
Source(s): Wells Fargo Securities and SMI Financial

### III. MARKET DISRUPTIONS

From the earliest years, crisis moments have served as defining points in the CMBS market. Three stand out. Early in the CMBS experience, the 1998 Asian currency crisis and Russian default illustrated that, through CMBS, bond market turmoil can reverberate back into commercial property prices. The disruption proved to be short-lived but deep losses at loan originators prompted new risk management practices. Growth resumed until three years later when the 9/11 terrorist attacks caused the destruction of several properties collateralizing CMBS. In the

administering real estate owned (“REO”) properties. The trustee and the certificate administrator generally perform administrative functions related to the trust and the certificates. These functions are often performed by the same entity. The trustee functions generally entail holding the assets of the trust for the benefit of the certificateholders and exercising certain rights on behalf of the certificateholders.”).

months following, the sudden scarcity of private sector insurance for terrorism risk caused significant uncertainty, but in 2002 Congress intervened with an insurance backstop program, and, with that, CMBS resumed with record breaking issuance in 2003. The third significant crisis moment, the 2008 financial crisis, has proved more lasting. Investor losses have been significant. Many aspects of the CMBS business have become subject to heightened regulation.

A. *The Asian Contagion, the Russian Flu, and the End of the Wonder Years*

In 1998, the CMBS market met with the first of three large market disruptions during the past twenty years. The chain of events that started with the collapse of the Thai Baht in July 1997, the ensuing collapse of other Asian currencies, culminating in the eventual default by Russia on its sovereign debt in August 1998, ended the “Wonder Years” in the CMBS market and CMBS issuance came to a halt.<sup>14</sup> This led to a more risk-averse market followed by a period of renewed, but more measured, growth.

Fallout from the 1998 market disruption was felt by both CMBS investors and lenders. CRIIMI Mae, a mortgage real estate investment trust, was one of the largest buyers of the below-investment grade CMBS tranches (known as “B-piece”).<sup>15</sup> Like other B-piece buyers, CRIIMI Mae used various strategies over time to achieve a shorter payback period than the more senior bonds in the respective CMBS transactions such as relying heavily on financing of their CMBS investments from investment banks. Amid the market turmoil of late 1998, widening spreads and declining bond prices left CRIIMI Mae facing margin calls, eventually causing CRIIMI Mae to file bankruptcy on October 5, 1998.

CRIIMI Mae was not the only casualty of the 1998 market

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14. Steven Radelet & Jeffrey Sachs, *The Onset of the East Asian Fin. Crisis*, NAT'L BUREAU OF ECON. RESEARCH (Working Paper No. 6680, 1998), <http://www.nber.org/papers/w6680.pdf>.

15. B-piece buyers are an integral part of the CMBS business. These investors buy the lowest, riskiest tranches in each CMBS transaction with commiserate risk-based yields and are awarded with some control over the disposition of defaulted loans. Furthermore, B-piece buyers are generally thought of by other CMBS investors as gatekeepers for CMBS collateral because B-piece buyers may remove loans that they view as objectionable from the CMBS pool of loans during the due diligence period prior to the securitization closing.



disruption. CMBS lenders and issuers learned that their interest rate hedging strategies were ineffective against the volatility created by this disruption. Although CMBS lenders believed that their loans were properly priced and hedged against such interest volatility, there was not a strong enough correlation between their interest rate hedges and interest rate movement. Due to the interest rate dislocation during this period, many lenders went back to their borrowers on transactions that had not yet closed and re-priced their loans. This created a wave of tension between borrowers, who believed in good faith they had binding pricing for their loans, and CMBS lenders, who could not afford to close loans with negative value. The disadvantages of the interrelationship between the capital markets and commercial real estate finance came into clear focus.

Many CMBS loan originators also relied on short-term financing, using bank warehouse facilities to borrow against their loans before selling these loans to securitizations. As the Asian and the Russian crises unfolded, the value of warehoused loans dropped precipitously. The decline in value of warehoused loans drove margin calls on these CMBS lenders. Where lenders did not have the capital necessary to meet the margin calls, warehouse facility lenders took possession of the loans in lieu of cash repayment, forcing some of these lenders out of business. Credit Suisse, Nomura, Merrill Lynch, Daiwa Securities, and WMF Capital were among the firms with major CMBS loan origination businesses that stopped originating loans for securitization after suffering large losses.<sup>16</sup>

Given this fallout, when the market returned in 1999, the emphasis was on risk reduction for CMBS lenders. Issuance “velocity” became a new strategic imperative.<sup>17</sup> Through issuance velocity, loan originators and issuers sought to limit their risk exposure by shortening the length of time between origination and securitization. To accomplish this, issuers shifted to smaller pools of loans with multiple loan originators contributing to the same loan pool in order to more frequently issue CMBS transactions. Prior to 1998, CMBS lenders generally looked

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16. Leah Nathans & Andrew Osterland, *Buried in Nomura's Real Estate Bubble*, BUSINESSWEEK, (Sept. 24, 1998), <http://www.businessweek.com/1998/40/b3598083.htm>.

17. Michael J. Acton & Michael Ervolini, *Evolution of the U.S. Commercial Mortgage Market and Its Implications for CMBS*, CMBS WORLD (1999), [http://www.crefc.org/Magazine/CMBS\\_World\\_Summer\\_1999/index.html#16/](http://www.crefc.org/Magazine/CMBS_World_Summer_1999/index.html#16/).

to contribute their collateral into a CMBS transaction between two and four times a year. Once the CMBS markets returned to some normalcy, lenders looked to include their loans as collateral to CMBS transactions with much more frequency, perhaps up to eight to ten times per year, hence the term “velocity”.

*B. 9/11*

The events of 9/11 affected the CMBS market directly. Four of the seven World Trade Center buildings were financed with CMBS loans, as were three nearby properties.<sup>18</sup> For bondholders, the then-existing insurance regime proved sufficient: The \$563 million GMAC 2001-WTC securitization, backed by four World Trade Center complex properties, experienced no interruptions to cash flow after 9/11 and was repaid in full out of insurance proceeds in 2003.<sup>19</sup> After 9/11, however, the insurance landscape changed. Property and casualty insurance providers began to exclude terrorism risk from all-risk policies while stand-alone insurance for terrorism risk became either unavailable or unaffordable.<sup>20</sup> Borrowers facing higher premiums were placed in conflict with servicers who were vested with the ability to force-place terrorism insurance to protect CMBS investors.<sup>21</sup>

CMBS transaction documents generally mandate that the borrower maintain comprehensive all-risk insurance from a qualified provider covering property replacement cost and business interruption. Prior to the 9/11 terrorist attacks, insurers rarely excluded or separately

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18. Buildings 1, 3, 4, and 5 of the World Trade Center were financed through a CMBS transaction, as were One Liberty Plaza, and 2 and 4 World Financial Center. *CMBS Quarterly Insights: The Shape of CMBS Since Sept. 11*, STANDARD & POOR'S STRUCTURED FIN. (Oct. 23, 2001).

19. *CMBS Quarterly Insights: Fourth-Quarter 2003*, STANDARD & POOR'S (Jan. 29, 2004).

20. Baird Webel, *Terrorism Risk Insurance: Issue Analysis and Overview of Current Program*, CONGR. RESEARCH SERV. 1 (Jul. 23, 2014) (“Because of the lack of public data on, or modeling of, the scope and nature of the terrorism risk, reinsurers felt unable to accurately price for such risks and largely withdrew from the market for terrorism risk insurance in the months following September 11, 2001. Once reinsurers stopped offering coverage for terrorism risk, primary insurers, suffering equally from a lack of public data and models, also withdrew, or tried to withdraw, from the market.”).

21. *Omni Berkshire Corp. v. Wells Fargo Bank, N.A.*, 307 F. Supp. 2d 534 (2004) (Upholding the ability of Wells Fargo as CMBS master servicer to force-place terrorism insurance coverage where a borrower had refused to pay the increased cost of a stand-alone terrorism insurance policy).

charged for terrorism risk. The subsequent unbundling of terrorism risk from other property insurance left borrowers choosing between paying cost-prohibitive premiums or risk defaulting on their loans.<sup>22</sup> The unavailability of terrorism insurance put the extension of new loans on hold.<sup>23</sup>

In 2002, Congress passed, and the President signed, the Terrorism Risk Insurance Act of 2002 (“TRIA”) to address the deadlock in terrorism insurance. Initially set up as a three-year program, TRIA required insurers to provide terrorism insurance to commercial policyholders and the program established a public-private loss-sharing arrangement.<sup>24</sup> TRIA proved to be a success, and, following its enactment, the availability of terrorism coverage improved and premium prices declined.<sup>25</sup> In January 2015, the Terrorism Risk Insurance Program was extended for a third time and now runs through 2020.<sup>26</sup>

Real estate market fundamentals were already weakening before the 9/11 attacks, reflecting a slowdown in the overall economy and the deflating dot-com bubble. Hotel defaults rose in the wake of the terrorist attacks. In the recession that followed, rents moved lower across property sectors and vacancies moved higher. Office vacancy rates, rose from 8.1% in mid-2000 to 10.8% by mid-2001, and then 12.3% a year later.<sup>27</sup>

The Federal Reserve responded to economic weakness with accommodative monetary policy, lowering the target federal funds rate from 6.50% in December 2000 to 1.00% by June 2003. Economic growth remained weak during the first part of the recovery, but due to lower interest rates, commercial real estate prices rebounded ahead of a recovery in fundamentals. By year-end 2003, the CMBS market was fully operational and issuance of \$77.8 billion for the year reached the highest on record.

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22. Poindexter, *supra* note 2, at 657.

23. *Id.* at 660.

24. Baird Webel, *Terrorism Risk Insurance: An Overview*, CONG. RESEARCH SERV. 1 (Apr. 11, 2005), <https://www.fas.org/sgp/crs/terror/RS21979.pdf>.

25. COMMERCIAL MORTG. SEC. ASS’N, TERRORISM INSURANCE AVAILABILITY FOR COMMERCIAL REAL ESTATE CAPITAL MARKETS, [https://www.crefc.org/uploadedFiles/CMSA\\_Site\\_Home/Government\\_Relations/CMSA\\_Issues/Terrorism\\_Insurance/Terrorism\\_Insurance\\_Position\\_Paper.pdf](https://www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/CMSA_Issues/Terrorism_Insurance/Terrorism_Insurance_Position_Paper.pdf)

26. Terrorism Risk Insurance Program Reauthorization Act of 2015, H.R. 26, 114th Cong. § 101 (2015).

27. Tad Philips & Sally Gordon, *What Now? CMBS in 2002*, CMSA WORLD 6 (Winter 2002).

*C. The Great Recession and the Great Regulation*

It generally takes a series of events to make a crisis. This series of events, including the credit expansion of the preceding decade followed by rising subprime mortgage delinquencies into early 2007, took on the character of a crisis in the summer of 2007 when two Bear Stearns Cos. hedge funds heavily invested in subprime mortgage bonds were liquidated.<sup>28</sup> The financial crisis emanated from subprime mortgages but called into question CMBS valuation and market practices. Extensive research has followed the financial crisis, and a number of conclusions apply to CMBS: (1) Many investors operated under some form of structural reliance on bond ratings, (2) Derivative products, including Collateralized Debt Obligations (“CDO”) and credit default swap indices abounded while their ability to artificially reduce the cost of capital was not well understood, and (3) Principal agent issues existed in the structuring deals.<sup>29</sup>

In 2001, U.S. bank regulators revised regulatory capital standards, for the first time allowing banks to record a lower capital charge for investment-grade CMBS than for a pool of commercial whole loans.<sup>30</sup> In fact, the risk based capital required for holding a AAA rated CMBS position was lower than the capital required against a commercial mortgage by a factor of five. Insurance companies, which operate under capital rules set by the National Association of Insurance Commissioners, similarly faced reduced capital charges against highly rated CMBS compared to commercial mortgages. Investment mandates at money market funds and pension funds also had investment restrictions tied to ratings.<sup>31</sup>

Regulatory capital favored highly rated securities, and financial innovation followed.<sup>32</sup> CDOs, for example, assembled and re-securitized

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28. Kate Kelly et al., *Two Big Funds At Bear Stearns Face Shutdown*, WALL ST. J. (June 20, 2007), at A1.

29. See Segoviano et al., *supra* note 10.

30. Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations, 66 Fed. Reg. 59614 (Nov. 29, 2001).

31. Christian Opp et al., *Rating Agencies in the Face of Regulation*, BERKELEY J. OF FIN. ECON. (Oct. 30, 2012) (concluding that, “Since these regulations are of first order relevance for institutional investors’ capital management, a AAA label is economically valuable, independently of the underlying information it provides about the risk of a security.”).

32. Darrell Duffe, *Innovations in Credit Risk Transfer: Implications for Financial*

lower-rated junior CMBS bonds, credit default swaps, mezzanine debt, and miscellaneous assets. Rating models assigned some benefit to the diversification between the assets, and, thus, the bulk of the CDO structures achieved AAA rating.<sup>33</sup> Structured investment vehicles (“SIVs”) invested in longer maturity assets and issued highly rated short maturity paper in the form of asset-backed commercial paper (“ABCP”). CDOs and SIVs became significant buyers of CMBS. The proliferation of derivative financial products became a hallmark of the period leading up to the financial crisis. Investors were able to make directional bets on CMBS prices through credit default swap indices known as CMBX.<sup>34</sup> The cumulative effect of these derivatives may help explain why the risk premium on CMBS bonds decreased from 2004 to 2007 even as the risk inherent in the product increased.<sup>35</sup>

Bond ratings became more accommodative leading up to the financial crisis.<sup>36</sup> Loan quality declined, evidenced by a rising share of interest-only loans in CMBS pools and an overall increase in loan leverage. Even as loan level leverage increased, the loss protection to achieve a certain rating continued to be lowered by rating agencies from 2004 to 2007.<sup>37</sup> More accommodative ratings followed a prolonged

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*Stability* 15 (Bank for Int’l Settlements, Working Paper No. 255, 2008), <http://www.bis.org/publ/work255.pdf> (noting that senior CDO tranches were often sold out). The fact that a typical CDO structure incorporates multiple classes of relatively senior tranches that are all sold out is evidence that CDOs were created in response to demand for certain classes of securities.

33. Anna Barnett-Hart, *The Story of the CDO Market Meltdown: An Empirical Analysis*, HARV. COLLEGE (Mar. 19, 2009), <http://www.hks.harvard.edu/m-rcbg/students/dunlop/2009-CDOmeltdown.pdf>.

34. Staff Report, *Clearinghouse Reveals CMBX Contract Volumes*, COMMERCIAL REAL ESTATE DIRECT (Nov. 13, 2008), [http://www.crenews.com/top\\_stories\\_subscriber/clearinghouse-reveals-cmbx-contract-volumes.html](http://www.crenews.com/top_stories_subscriber/clearinghouse-reveals-cmbx-contract-volumes.html) (“CMBX contracts totaling \$265 billion in gross notional value are outstanding, and more than half of that is comprised of contracts against super-senior AAA bonds. In addition, about \$10.8 billion of notional value of CMBS credit-default swaps are outstanding.”).

35. The spread to Treasuries, or risk premium, on newly-issued BBB CMBS bonds, for example, decreased from 90 bps at the beginning of 2004 to 75 bps in late 2006, even as the subordination, or loss absorption capacity, of the bonds decreased from 4.93% on average in 2004 to 4.25% in 2006 and underlying loans increasingly consisted of interest-only loans and overall loan leverage moved higher.

36. The 1997 Note identified the potential investor misunderstanding of the role of rating agencies as a then existing criticism of CMBS. Kronovet, *supra* note 1, at 289–90.

37. Richard Stanton & Nancy Wallace, *CMBS Subordination, Ratings Inflation, and the crisis of 2007-2009* 42–43 (Nat’l Bureau of Econ. Research, Working Paper No. 16206, 2010) (“During the crisis, while commercial loans bore their share of defaults, realized defaults were in line with levels observed over almost the whole of the 40-year period before the crisis,

period of low defaults and losses in CMBS loans. Exhibit 4 illustrates the aftermath of ratings inflation. By year-end 2015, losses had wiped out 71.5% of the original balance of BBB rated CMBS issued in 2006. Losses will ultimately end up higher still as the remaining loans reach maturity in 2016.

**Exhibit 4: Cumulative Losses by Original Class Rating Conduit CMBS<sup>38</sup>**

Original Rating	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
AAA	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.02%	0.07%	0.09%	0.00%
AA+	0.00%	-	-	-	0.00%	0.00%	0.00%	0.00%	0.00%	4.64%	9.47%
AA	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	1.40%	7.13%	11.75%	19.87%
AA-	-	-	-	0.00%	0.00%	0.00%	0.58%	3.02%	13.33%	19.61%	17.39%
A+	-	-	0.00%	0.00%	0.00%	0.00%	0.00%	6.51%	16.33%	23.64%	35.44%
A	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	1.75%	4.83%	21.12%	36.37%	43.13%
A-	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	1.98%	10.00%	41.76%	41.79%	55.43%
BBB+	-	-	0.00%	0.30%	2.58%	0.00%	5.36%	17.82%	60.87%	51.27%	70.04%
BBB	0.00%	0.00%	0.00%	1.53%	8.01%	3.29%	9.63%	33.59%	71.53%	56.85%	78.43%
BBB-	0.00%	0.00%	0.68%	11.91%	12.54%	8.74%	20.27%	51.89%	81.04%	71.70%	81.79%
BB+	2.26%	0.77%	7.90%	26.23%	22.17%	13.29%	25.65%	61.01%	90.03%	76.28%	86.31%
BB	2.63%	6.57%	30.97%	38.88%	29.37%	22.64%	36.67%	76.09%	90.43%	84.85%	90.33%
BB-	7.60%	15.07%	64.17%	67.14%	38.62%	35.61%	52.10%	83.63%	94.19%	87.54%	92.87%
B+	5.16%	30.47%	75.02%	84.35%	55.05%	57.92%	58.19%	88.28%	96.92%	90.47%	100.00%
B	18.09%	41.35%	85.00%	81.44%	59.49%	58.59%	65.73%	90.00%	97.33%	98.13%	100.00%
B-	59.64%	68.17%	94.09%	90.54%	69.03%	64.32%	77.76%	94.08%	99.55%	100.00%	100.00%

\*Excludes rake bonds and interest-only tranches. Not all transactions include every rating level, which can result in higher-rated classes showing higher loss rates than lower-rated classes for some vintages.

Source: Trepp, LLC, and Wells Fargo Securities, LLC.

CDOs intensified an existing agency problem in the CMBS market. B-piece buyers, who had been viewed as gatekeepers of loan quality, were able to sell their holdings into CDOs and realize a profit upfront, undermining the incentive to perform comprehensive due diligence.<sup>39</sup> The agency problem was not an entirely new development

excluding the most recent few years . . . . [B]oth before and during the crisis, the only significant shift in the market was the reduction in allowable subordination levels by the rating agencies. It is possible that these over-optimistic subordination levels were caused by too much reliance on very recent default data.”).

38. The chart summarizes realized losses as a percentage of original balance by original rating calculated through year-end 2015.

39. Adam B. Ashcraft et al., *Does Skin in the Game Affect Security Performance? Evidence from the Conduit CMBS Market* (Apr. 2014), [http://experiments.cob.calpoly.edu/seminars/RiskRetention\\_30march2014-1.pdf](http://experiments.cob.calpoly.edu/seminars/RiskRetention_30march2014-1.pdf) (“The creation of CRE CDOs combined with generous ratings given to these CRE CDOs provided an exit strategy for B-piece buyers that enabled them to have less exposure to the risk associated with the underlying loans in conduit/fusion CMBS deals.”); Adam J. Levitin &

because B-piece buyers have typically recovered the full value of their investment before more senior bondholders.<sup>40</sup> CDO structures, however, allowed these investors to realize an immediate profit by selling the B-piece into a CDO concurrent with the CMBS deal pricing.

What had started with a rise in subprime delinquencies became a credit crunch and then an economic recession. After peaking at over \$500 billion in 2007, the transaction volume in commercial dropped to \$54.4 billion in 2009. Property prices declined 43.7% from the highs reached in Oct. 2007 to October 2009.<sup>41</sup>

#### D. Borrower Bankruptcies

A primary concern identified in the 1997 Note related to bankruptcy: (1) the risk that assets securitized by an issuer would be reclaimed in the event the issuer filed for bankruptcy, or (2) creditors of the bankrupt issuer would not have access to the securitized assets.<sup>42</sup> The risks posed by an issuer bankruptcy did not become an issue for CMBS transactions in the wake of the financial crisis. However, an unforeseen issue was the ability of borrowers to restructure loans in bankruptcy. Several examples emerged, which are likely to have a more lasting impact on CMBS.

Securitization exists to finance assets separate and apart from the risks and creditworthiness of any other entity involved in the assets.<sup>43</sup> This isolation of risk is achieved by relying on two bedrock legal concepts: (1) a true sale of the assets, and (2) the formation of a separate

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Susan M. Wachter, *The Commercial Real Estate Bubble*, 3 HARV. BUS. L. REV. 83 (2013), [http://www.hblr.org/wp-content/uploads/2013/08/HLB108\\_crop.pdf](http://www.hblr.org/wp-content/uploads/2013/08/HLB108_crop.pdf) (finding that B-piece buyers were buying conduit exposure with the intent to sell into CDOs).

40. Using a hypothetical example, a buyer purchasing a B-piece at a price equating to an 18% yield would recoup the full investment before six years. Bondholders investing in the 10-year classes of the deal, who are theoretically more senior in the priority of payments, would depend on loans repaying over the entire 10-year deal term for a full recovery of principal.

41. Moody's Investors Service, Inc., *Moody's/REAL Commercial Property Price Indices, December 2009* (Dec. 21, 2009).

42. Kronovet, *supra* note 1, at 311.

43. Thomas E. Plank, *The Security of Securitization and the Future of Security* 25 CARDOZO L. REV. (2004); University of Tennessee Legal Studies Research Paper No. 55 at 1662, <http://ssrn.com/abstract=1334831> (The principal value of securitization flows from the separation of risks of the assets from those of the originator). Securitization lowers the financing costs for borrowers and originators of loans by avoiding the costs imposed by the Bankruptcy Code on the secured creditors of operating companies.

legal entity to hold the assets for the benefit of investors.<sup>44</sup> Assets are held in a special purpose entity (“SPE”) with the express intent of eliminating the risk of a bankruptcy filing by this entity or the risk of entangling the securitized assets in a parent company’s bankruptcy. The purpose of this structure is summed up with the commonly used term, “bankruptcy remote entity.”<sup>45</sup>

This isolation of corporate risk from asset risk has been credited with creating liquid tradable instruments out of illiquid assets, lowering financing costs for issuers, and opening avenues to more efficient asset allocation for investors.<sup>46</sup> And yet, even though vast sums of capital are committed in reliance on the legal principles underlying securitization,<sup>47</sup> the separation of securitized assets has not been consistently upheld in

44. A true sale is a vital in distinguishing the securitization from a loan, “This separation is achieved by structuring the sale of assets between the transferor and the SPE as a “true sale” between the parties rather than a transfer of the security interest in the assets. “In a securitizations true sale, the originator must absolutely assign, transfer, and divest of all ownership rights, title, or interest in its assets to the SPV. John A. Pearce & Ilya A. Lipin, *Special Purpose Vehicles in Bankruptcy Litigation*, 40 HOFSTRA L. REV. 197 (2011) (citing *Lasalle Nat’l Bank v. Paloian*, 406 B.R. 299 (7th Cir. Ill. 2010)).

45. “The special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur.” FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140, App’x A. § 83(c). In order to achieve this risk management objective, SPE organizational documents typically have three fundamental characteristics: (1) such documents limit the SPE’s objects and powers, (2) such documents create structural obstacles to the SPE’s filing for bankruptcy for reasons not related to the financial condition of the project, typically requiring the consent of directors or managers of the SPE who are independent of the sponsor, and (3) reinforced by the credit documents, such organizational documents impose separateness covenants that limit bankruptcy risk by generally requiring the SPE to operate as a stand-alone entity and limiting the SPE’s ability to incur obligations unrelated to the securitized financing. COMM. ON STRUCTURED FIN. OF THE ASS’N OF THE BAR OF THE CITY OF N.Y., STRUCTURING COMMERCIAL MORTGAGE SECURITIZATION SPECIAL PURPOSE ENTITIES AFTER GENERAL GROWTH PROPERTIES, (July 2010), <http://www.nycbar.org/pdf/report/uploads/20071978-StructuringCommercialMortgageSecurizations.pdf>

46. Edward L. Glaeser, *Debating the Securitization of Mortgages*, THE N.Y. TIMES (July 27, 2010) [http://economix.blogs.nytimes.com/2010/07/27/debating-the-securitization-of-mortgages/?\\_r=0](http://economix.blogs.nytimes.com/2010/07/27/debating-the-securitization-of-mortgages/?_r=0) (describing some of the benefits of securitization and its role in helping the current economy); *Securitisaton It’s Back*, THE ECONOMIST (Jan. 11, 2014), <http://www.economist.com/news/leaders/21593457-once-cause-financial-worlds-problems-securitisation-now-part-solution-its>.

47. Issuers of asset-backed securities (securitization) financed non-mortgage business and consumer loans of \$1.39 trillion at year-end 2015. SEC. INDUST. AND FIN. MKTS. ASS’N, STATISTICAL RELEASE, U.S. ABS ISSUANCE AND OUTSTANDING. Securitizations of single-family mortgages amounted to \$7.08 trillion. SEC. INDUST. AND FIN. MKTS. ASS’N, STATISTICAL RELEASE, U.S. MORTGAGE-RELATED ISSUANCE AND OUTSTANDING. Of most relevance here, securitization financed \$582.8 billion of commercial mortgages. (*Id.*)



court.<sup>48</sup> Long before the financial crisis, *LTV Steel* served as the leading case illustrating the broad powers of bankruptcy courts under section 105 of the Bankruptcy Code<sup>49</sup> and defining the estate of the debtor under section 541.<sup>50</sup> In *LTV Steel*, the court allowed a bankrupt debtor access to the cash collateral held by two securitization SPEs and included those non-filing entities in the bankruptcy estate.<sup>51</sup> The *LTV Steel* case foreshadowed challenges that would face the CMBS market starting in 2009.

From the fallout from the 2008 financial crisis came three bankruptcy cases, filed in short succession, of lasting significance to CMBS: *General Growth Properties*<sup>52</sup> and *Extended Stay*<sup>53</sup> in 2009, followed a year later by *Innkeepers*.<sup>54</sup> These three cases brought into direct conflict the broad powers of bankruptcy courts with the asset isolation measures central to the securitization process. The ability of debtors to include “bankruptcy remote” SPEs in their bankruptcy estates, to access securitization cash flow to fund their re-organizations, and their success in modifying the terms of their securitized loans undermined core tenets of CMBS.

### 1. General Growth Properties

Facing the prospect of upcoming loan maturities amid a CMBS market that had seen no new deals issued since 2008, General Growth Properties, Inc. (“GGP”), a shopping center operator, filed a voluntary Chapter 11 bankruptcy petition on April 16, 2009.<sup>55</sup> The bankruptcy

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48. *In re LTV Steel Co.* 274 B.R. 278 (Bankr. N.D. Ohio 2001) (exemplifying the unwillingness by courts to consistently uphold the separation of securitized assets prior to the financial crisis).

49. Samantha J. Rothman, *Lessons From General Growth Properties: The Future of the Special Purpose Entity*, 17 *FORDHAM J. OF CORP. & FIN. L.* 227, 235–36.

50. *In re LTV Steel Co.* 275 B.R. 278, 285–86 (Bankr. N.D. Ohio 2001) (finding assets of subsidiaries to be part of the debtor’s bankruptcy estate).

51. John A. Pearce II and Ilya A. Lipin, *Special Purpose Vehicles in Bankruptcy Litigation*, 40 *Hofstra L. Rev.* 177, 204 (“The LTV case demonstrates that despite financially damaging effects for the SPV’s investors, a bankruptcy court may allow the parent-originator to use liquid assets it previously sold to a bankruptcy-remote SPV to prevent negative consequences that the originator’s bankruptcy would have on its employees, retirees and regional economics.”)

52. *In re Gen. Growth Properties, Inc.*, 409 B.R. 43, 46 (Bankr. S.D.N.Y. 2009).

53. *In re Extended Stay Inc.*, 435 B.R. 139, 144 (S.D.N.Y. 2010).

54. *In re Innkeepers USA Trust*, 448 B.R. 131, 138 (Bankr. S.D.N.Y. 2011).

55. *In re Gen. Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009). GGP’s

filing was significant to the CMBS market because at the time of its filing GGP was the second largest mall operator in the United States and the largest borrower in the CMBS market with loans securitized in many deals.<sup>56</sup> Along with its bankruptcy filing, GGP also caused 160 property-owning SPE CMBS borrowers to file voluntary Chapter 11 petitions. The bankruptcy for GGP and the SPEs became jointly administrated.

CMBS investors, represented by special servicers, clashed with GGP on three fronts during the bankruptcy: (1) Investors argued that certain CMBS properties should not have been included in the bankruptcy in the first place; (2) CMBS investors disputed the company's ability to use cash flow from SPEs during the pendency of its reorganization; and (3) Investors were dealt restructured terms that extended loan maturities and waived prepayment penalties.

A group of lenders sought to dismiss the bankruptcy filings of certain SPEs asserting that the bankruptcy filings of these entities were made in "bad faith".<sup>57</sup> The lenders argued, in essence, that these GGP SPEs were not properly the subject of a Chapter 11 reorganization because the SPEs were not in financial distress. In support of an assertion of "bad faith", the lenders relied on two facts: (1) GGP had replaced independent managers of many SPEs immediately before filing for bankruptcy with appointees that would not oppose bankruptcy,<sup>58</sup> and (2) GGP failed to negotiate with the SPE lenders before filing for bankruptcy.<sup>59</sup> The court denied the motions to dismiss, finding the actions of GGP did not constitute bad faith. The court further concluded that as directors of a Delaware corporation, the independent directors had

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business model relied on continued access to the capital markets to refinance property loans. *Id.* at 53. At the time of its filing, GGP financed \$15.0 billion of its \$27.3 billion in prepetition debt through CMBS. The company cited the lack of financing in the CMBS market as precipitating the need to file for bankruptcy. As additional context, hedge fund Pershing Square Capital Management disclosed that it had acquired a 7.4% stake in the company in January 2009. GGP's bankruptcy filing may have been somewhat opportunistic, citing debt maturities three years into the future.

56. The company's business model relied on access to mortgage capital, primarily CMBS, to refinance maturing debt, and \$18.27 billion of its \$27.3 billion in prepetition debt had been financed in the form of secured borrowings from property-owning SPEs.

57. Motion of ING Clarion Capital Loan Services LLC, Pursuant to 11 U.S.C. § 1112(b), to Dismiss the Cases of Bakersfield Mall LLC; RASCCAP Realty, Ltd.; Visalia Mall, L.P.; GGP-Tucson Mall L.L.C.; Lancaster Trust; HO Retail Properties II Limited Partnership; RS Properties Inc.; Stonestown Shopping Center L.P.; and Fashion Place, LLC (*In re General Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

58. *In re Gen. Growth Props.*, 409 B.R. 43, 49–51, 63–65 (Bankr. S.D.N.Y. 2009).

59. *Id.* at 37–38.

a duty to act in the interest of the corporation (*i.e.*, the SPE) and its shareholders (*i.e.*, GGP),<sup>60</sup> and therefore acted appropriately in placing the SPEs in bankruptcy.

GGP also came into conflict with CMBS investors over the use of property cash flow during the pendency of the bankruptcy. Loan documents provided that cash flow from properties would be deposited into lender-controlled accounts in the event of a borrower default such as a bankruptcy filing.<sup>61</sup> GGP sought the court's permission to override these "lock-box" provisions and instead continue to direct property cash flow into the parent company's accounts as had been the practice prior to the bankruptcy filing. The company's cash management would adversely affect the SPEs security and would violate the separateness covenants. The bankruptcy court granted GGP access to cash collateral but also granted the SPE lenders (the various CMBS Trusts) an adequate protection lien on GGP's main operating account and on intercompany loans, which evidenced the upstream flow of cash.<sup>62</sup> In practical terms, the court order meant cash collateral from the individually-created SPEs could be used for purposes unrelated to the specific SPEs that generated the cash flows.

The GGP bankruptcy was also significant because the company succeeded in modifying the terms of its CMBS loans—with no objections from creditors by this point.<sup>63</sup> Restructured loan terms generally included maturity date extensions, the waiver of limitations on loan prepayments, and, in some instances, the suspension of principal payments.<sup>64</sup>

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60. *Id.* at 68.

61. Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 B.Y.U. L. REV. 759, 804 (2013) ("[T]hese rents constituted the secured creditors' cash collateral.").

62. J. Eric Ivester et al., *Using the Chapter 11 Process to Restructure REITs*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (May 2010), [https://www.skadden.com/sites/default/files/publications/REIT\\_CMBS\\_Restructurings\\_in\\_a\\_Chapter\\_11\\_Environment.pdf](https://www.skadden.com/sites/default/files/publications/REIT_CMBS_Restructurings_in_a_Chapter_11_Environment.pdf); see also James Gadsden, *General Growth Properties and Its Aftermath, Hot Topics In Structured Finance*, CARTER LEDYARD & MILBURN LLP (Mar. 2010), [http://www.clm.com/docs/6557479\\_3.pdf](http://www.clm.com/docs/6557479_3.pdf).

63. Dick, *supra* note 61, at 808 ("With the SPEs safely in bankruptcy and GGP authorized to use the SPEs' rental income, SPE creditors were highly incentivized to agree to a restructuring of the mortgage loans.").

64. *In re Gen. Growth Props., Inc.*, No. 09-11977, 2010 Bankr. LEXIS 5943 (U.S. Bankr. S.D.N.Y. Oct. 21, 2010)

## 2. Extended Stay

Two months after the GGP filing, Extended Stay, Inc. (“ESH”), a large limited-service hotel operator, filed for bankruptcy, again bringing “bankruptcy remote” property owning entities into court with the corporate parent.<sup>65</sup> The purchase of the ESH hotel chain two years earlier had been financed by \$7.4 billion in debt consisting of a \$4.1 billion in CMBS debt, and \$3.3 billion of mezzanine loans.

At origination, the CMBS loan had been structured with extensive special purpose entity and separateness representations and covenants.<sup>66</sup> While these measures did not keep the CMBS debt out of the bankruptcy court, a personal guaranty executed against the principal of the borrower under the CMBS loan was upheld.<sup>67</sup> At structuring, the loan included a \$100 million personal guaranty by David Lichtenstein that would be triggered if the company filed for bankruptcy. Ultimately, the restructuring resulted in the sale of the hotel chain to two private equity firms. The transaction was accomplished by refinancing the CMBS debt and extinguishing the \$3.3 billion of mezzanine debt.<sup>68</sup>

## 3. Innkeepers

As the *Extended Stay* case was moving to a final plan confirmation in July 2010, Innkeepers USA filed for bankruptcy. Similar to ESH, Innkeepers was a large hotel chain that relied on the CMBS market to help finance a 2007 leveraged buyout. As with GGP and ESH, the Innkeepers bankruptcy was to be financed with cash collateral from the property SPEs. All property cash flow was commingled and applied to a waterfall that paid operating expenses, corporate overhead, bankruptcy professional fees, and debtor-in-possession financing ahead of CMBS debt, while the CMBS creditors were granted adequate protection.

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65. *In re Extended Stay Inc.*, 418 B.R. 49 (Bankr. S.D.N.Y. 2009).

66. *In re Extended Stay, Inc.*, No. 09-13764 (JMP), Report of Ralph Mabely as examiner, 73 (2010) (summarizing 13 such requirements citing to the Mortgage Loan Agreement and Mezzanine Loan Agreements).

67. *Bank of Am., N.A. v. Lightstone Holdings, LLC*, 2011 NY Slip Op 51702(U), 938 N.Y.S.2d 225 (Sup. Ct. 2011).

68. Edward L. Shugrue III, *Extended Stay America-Back to the Future*, 16 CRE FIN. WORLD (2014), [http://www.talmagellc.com/pdfs/ESA-Back\\_to\\_the\\_Future\\_Article.pdf](http://www.talmagellc.com/pdfs/ESA-Back_to_the_Future_Article.pdf).

Bankruptcy for Innkeepers eventually meant a restructuring of the CMBS debt held across a number of different trusts. For example, the largest CMBS loan, an \$825.4 million original balance fixed-rate loan, saw its balance reduced by 12% while principal payments were deferred, and the prepayment penalties were waived. The case created precedent for the proposition that individual CMBS investors do not have standing to sue, with the exceptions of certain contractually prescribed provisions set forth in the Pooling and Servicing Agreement (“PSA”),<sup>69</sup> as they ceded that right to the special servicer pursuant to the terms of the PSA.<sup>70</sup>

#### IV. POST-CRISIS MARKET REGULATION AND THE OUTLOOK FOR CMBS

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”) became the central legislative response to the 2008 financial crisis.<sup>71</sup> While sweeping in scope, Dodd-Frank focused on securitization as the target of legislative and regulatory attention. Among its key securitization objectives, Dodd-Frank addressed the alignment of interests between issuers and investors, broadened the information disclosed to investors, and tightened oversight of the bond ratings process. Flowing from Dodd-Frank and the U.S. implementation of the Basel III capital framework, trading in CMBS has also become subject to more regulatory oversight and higher capital costs.

The risk retention component, or “skin in the game” provisions, of Dodd-Frank make up the law’s most significant securitization reform. The law required regulatory agencies to draft a rule requiring that the sponsor of a securitization retain a 5% loss exposed interest in the credit risk of any asset transferred to a securitization.

While Congress created a legislative framework for securitization reform, Dodd-Frank left significant gaps to be filled through

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69. Amy Loftsgordon, *Understanding Basic Mortgage Transactions and Securitized Loans*, NOLO, <http://www.nolo.com/legal-encyclopedia/what-pooling-servicing-agreement-psa-the-mortgage-industry.html>.

70. *In Brief: CMBS Certificate Holders Lack Standing In Chapter 11*, Business Restructuring Review, JONES DAY, [http://www.jonesday.com/files/Publication/b21339e2-0f69-4be2-8a85-3716d3492f5c/Presentation/PublicationAttachment/6009672a-9045-47aa-aa29-3a2a28f8e8fc/BRR\\_May\\_June\\_11.pdf](http://www.jonesday.com/files/Publication/b21339e2-0f69-4be2-8a85-3716d3492f5c/Presentation/PublicationAttachment/6009672a-9045-47aa-aa29-3a2a28f8e8fc/BRR_May_June_11.pdf)

71. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

administrative agency rulemaking.<sup>72</sup> The risk retention component of the rule involved six regulatory agencies, and took more than three years to move through the notice and comment process.<sup>73</sup> The finalized rule applies to deals issued after December 24, 2016, some six years after the passage of its enabling legislation.

Within this mandate, the Dodd-Frank statute instructed agencies to take into consideration the “B-piece” construct already in place in the CMBS market by allowing a third-party B-piece buyer to serve as a substitute for the CMBS issuer’s risk retention obligation. Under the implementing rule, where this option is used, the B-piece buyer would be subject to a five-year minimum holding period, limitations on financing the B-piece, and other restrictions on selling and hedging its interest. By requiring permanent, at-risk capital be maintained in each deal, the risk retention rule promises to transform the “originate-to-sell” business model on which the CMBS market has historically operated.

In addition to targeting the alignment of incentives through risk retention, Dodd-Frank seeks to make more information available to investors. The law serves this end through a number of provisions which include: required detailed periodic asset-level disclosures under Section 942(b);<sup>74</sup> disclosure detailing an issuer’s pre-securitization asset review process under Section 945;<sup>75</sup> disclosure of loan repurchase requests under Section 943;<sup>76</sup> and a summary to be provided by the rating agencies describing how the representations, warranties, and enforcement mechanisms in a particular deal differ from other similar issuances also under Section 943.<sup>77</sup>

#### The Securities and Exchange Commission’s (“SEC”) Regulation

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72. Richard A. Epstein, *Government by Waiver*, 7 NAT’L AFF. 39 (2011) (“The 848-page law creates a host of new regulatory agencies and powers to oversee the financial industry. Addressed to a sector of the economy in which clear and predictable rules are especially important, the law is astonishingly vague and broad, leaving regulators — including new agencies with no experience or track record — with unprecedented freedom to draw up the rules.”)

73. Credit Risk Retention, Exchange Act Release No. 34-73407, 79 Fed. Reg. 77,602 (Dec. 24, 2014) (to be codified at 24 C.F.R. pt. 267).

74. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 942(b), 15 U.S.C. § 77g(c) (2014).

75. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 945, 12 U.S.C. § 77g(d) (2014).

76. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 943, 15 U.S.C. § 78o-7 (2014).

77. *Id.*

AB II (“Reg AB”) does the heavy lifting in terms of implementing Dodd-Frank’s securitization investor reporting mandates.<sup>78</sup> The rule sets out standardized asset-level disclosures to be filed at the time of the securitization and on an ongoing basis. Along with these required disclosures, the rule also inserts more time into the deal marketing process, presumably to allow investors additional time to perform due diligence.<sup>79</sup> Reg AB also requires the chief executive officer of the depositor to make a certification as to the veracity of the disclosures in the prospectus. Reg AB further mandates the appointment of an asset reviewer that polices compliance with the representations and warranties made by the loan originator at issuance.<sup>80</sup> The bulk of these provisions went into effect in November 2015, while the asset disclosure provisions take effect in November 2016. Pre-dating Reg AB, the pre-existing standard for CMBS reporting has been the CRE Finance Council’s Investor Reporting Package, which is the work product of a long-term collaborative effort between investors, issuers, servicers, and other market participants.

Dodd-Frank proceeds along two fronts to reform the bond rating system. First, the law targets the rating process directly by imposing requirements for expanded information disclosure, heightened liability, and closer SEC oversight.<sup>81</sup> The information provided to rating agencies by servicers must follow the specific protocols established in § 17(g)-5. The purpose of this reform is to ensure that all rating agencies interested

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78. Reg AB was originally adopted in 2004. The SEC initiated an update of the rule through an NPR in April 2014. The SEC then re-proposed revisions to the rule in July 2011 after the enactment of the Dodd-Frank Act, and adopted the final rule in Aug. 2014. Sec. & Exch. Comm’n., Asset-Backed Securities Disclosure and Registration, Exchange Act Release Nos. 33-9638, (Aug. 27, 2014), <https://www.sec.gov/rules/final/2014/33-9638.pdf>.

79. The rule does this by requiring the delivery of a preliminary prospectus at least three days prior to pricing and the filing of a prospectus supplement disclosing any material changes at least 48 hours before pricing. The rule allows for more communication and coordination between bondholders.

80. The Second Circuit has thrown a spanner into the works with its decision in *Ace Securities v. DB Structured* products, which applies the New York statute of limitations period of six years to rep and warranty repurchase claims. In the current state of play, the asset reviewer may have a mandate to review rep and warranty breaches late in the deal life when there may no longer be a legally valid claim for enforcement. *ACE Sec. Corp., etc. v. DB Structured Prods., Inc.*, 2014 NY Slip Op 76202, 2014 N.Y. LEXIS 1406, 23 N.Y.3d 906 (2014).

81. See SEC. & EXCH. COMM’N, NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS, EXCHANGE ACT RELEASE NO. 34-72936, (Nov. 14, 2014), <https://www.sec.gov/rules/final/2014/34-72936.pdf>.

in evaluating a securitization have equal access to information to perform their analysis and assign a rating. The second reform made in Dodd-Frank, through Section 939A, ordered that references to credit ratings be removed from all federal regulation. The primary effect has been to eliminate the reliance on ratings for purposes of determining bank regulatory capital.<sup>82</sup>

In addition to deal structure, investor reporting, and ratings, bond trading became the subject of regulatory reform. Here, three rules come into play. The Volcker Rule, § 619 of Dodd-Frank, prohibits banks from engaging in proprietary trading, meaning trading purely for short-term profit in the bank's own accounts.<sup>83</sup> While in principle the rule sounds straightforward, as implemented it is less so, and relies on subjective metrics such as an estimate of expected near-term investor demand in a particular security. Bank capital rules have been revised to raise the capital costs associated with holding higher-risk securitization exposures.<sup>84</sup> Finally, the Financial Industry Regulatory Authority is moving forward with plans to require the disclosure of more information on individual CMBS trades.<sup>85</sup>

## V. CONCLUSION

Given the breadth of the regulations that have attached to the CMBS market since the financial crisis, the cumulative impact may not be apparent for some time. On the whole, it is reasonable to expect costs and frictions to securitizations to increase. On the other hand, competing sources of funding to commercial real estate are not affected by these rules. An insurance company, for example, does not face the same heightened constraints on underwriting a commercial real estate mortgage for its own balance sheet.

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82. Jeffrey Manns, *Downgrading Rating Agency Reform*, 81 GEO. WASH. L. REV. 749 (Apr. 2013), <http://www.gwlr.org/wp-content/uploads/2013/04/Manns.pdf>.

83. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 619, 12 U.S.C. § 1851 (2014).

84. Risk-Based Capital Guidelines: Market Risk. Fed. Reg. Vol. 78, No. 243 (codified at 12 CFR 325) [https://www.fdic.gov/news/board/2012/2012-06-12\\_notice\\_dis-a.pdf](https://www.fdic.gov/news/board/2012/2012-06-12_notice_dis-a.pdf)

85. FIN. INDUS. REG. AUTH., REGULATORY NOTICE, TRADE REPORTING AND COMPLIANCE ENGINE, (Feb. 9, 2015) (comment period expired Apr. 10, 2015), [https://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Notice\\_Regulatory\\_15-04.pdf](https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-04.pdf).



Therefore, as the post-crisis regulations come into effect, CMBS will likely cede market share of the commercial mortgage market to other sources of capital, including banks, life insurance companies, and Fannie Mae and Freddie Mac. The extent to which these regulations diminish the role of CMBS will not be fully evident for years. That said, the innovative spirit that marked the development of CMBS to date is not to be counted out.