Loan Modifications and Pool Management in a CRE CLO

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Key Takeaways

- CRE CLOs are attractive exit strategies for lenders of commercial bridge loans, in part due to the flexibility the structure provides in the modification of performing loans.
- In light of adverse financial market conditions, collateral managers have been fielding an increased number of requests for modifications and relief.
- Collateral managers have a number of available options for modifying performing loans, and thoughtful modifications can help issuers manage the pool of mortgage loans to protect investors while giving borrowers flexibility in implementing their business plans.

Overview

The commercial real estate collateralized loan obligation ("CRE CLO") has, over the last decade, become an increasingly popular vehicle for securitizing commercial mortgage loans. The collateral backing CRE CLOs generally includes short-term, floating-rate commercial mortgage loans on transitional properties which, compared to loans on fully stabilized properties, generally require more attentiveness on the part of the lender. The ability to actively manage the mortgage loans in the pool is a significant reason why issuers find CRE CLOs attractive.

In a CRE CLO, the collateral manager (or the holder of the subordinate class)[1] works with the servicer and the special servicer to field requests from borrowers and generally manage the borrower relationship. The most common tax structure for a CRE CLO is a "qualified REIT subsidiary" ("QRS") model, in which the issuing entity is treated as a "qualified REIT subsidiary" of a parent real estate investment trust ("REIT") and is therefore exempt from paying tax on its income, as long as it and its parent comply with the applicable REIT rules. In contrast to other tax structures, such as a real estate mortgage investment conduit ("REMIC") or a fully offshore vehicle which is not engaged in a United States trade or business, the QRS CRE CLO provides the most flexibility for administering and modifying high-touch loans. This is largely due to the fact that performing loans may be modified in a QRS, whereas significant modifications on performing loans are subject to various restrictions in both REMICs and fully offshore vehicles.

In light of adverse financial market conditions, lenders and borrowers are revisiting borrowers' business plans for stabilization, and collateral managers are fielding an increased number of borrower requests for loan modifications and other relief. In this OnPoint, we summarize some of the issues that collateral managers should consider when dealing with CRE CLO loan modifications. Lastly, we discuss available options if modifications do not sufficiently remediate the loan and the loan becomes distressed.

Partitioned Loans with Two or More Interest Holders: Who Has Control of the Loan?

The first issue is to determine which stakeholders in the process get to make the decision, and which other stakeholders have a say. Many loans backing CRE CLOs are partitioned in some form. Some of these loans are

[1] In static structures without a collateral manager, many of the same rights and responsibilities are vested in the holder of the subordinate class of securities issued by the CRE CLO. For the sake of simplicity, we refer to this party as the "collateral manager" regardless of whether the CRE CLO is static or managed.

divided into two or more participation interests, most often for the purpose of isolating any future funding obligation of the lender in a party other than the CRE CLO issuer. Some loans are partitioned into multiple notes, the administration of which is governed by a co-lender agreement, in an arrangement that is more typical of a conduit or single-asset CMBS transaction. Some loans even have several notes which are each subject to individual participation arrangements. In any event, the result is the same: two or more persons with an economic interest in a loan have agreed among themselves as to who gets to direct the servicer and the special servicer in its administration.

The participation agreement is the agreement that governs the relationship between the holders of interests in the loan.[2] Generally, the participation agreement will designate one party as the "Controlling Holder," and the Controlling Holder will have the right to give direction to the servicer and the special servicer in respect of loan modifications and consents. The Controlling Holder may not necessarily be the holder of the participation in which the loan is serviced. The participation agreement will typically contain a list of actions and decisions for which non-Controlling Holders have certain consent or consultation rights, which may vary depending on whether the loan is performing, defaulted or credit-risk.

Typically, this consent and consultation process is far more burdensome when interests are held among unaffiliated third parties. It is far simpler for obvious reasons to form a consensus among affiliates. However, it is important to consider other arrangements pursuant to which other participation interests may be financed. For example, often times, non-securitized participations are financed under a warehouse or repurchase facility, pursuant to which one or more non-securitized participations will be pledged or sold to a lender or buyer. Under the governing documents for that facility, the lender or buyer will likely have certain consent or consultation rights to the extent that those rights are held by the holder of the collateral participation, and you should review your repurchase agreements to determine what actions would require consent of, or consultation with, the lender or buyer. In addition, partitioned interests can be securitized in more than one CRE CLO. This is generally unproblematic, as all interests in the loan will be serviced under the same servicing agreement, and CRE CLOs in a particular program or series will typically retain the same servicer, special servicer and collateral manager. However, this can get more complicated when interests in the same loan are shared between CRE CLOs with different transaction parties and stakeholders.

Division of Labor Between the Collateral Manager, the Servicer and the Special Servicer

Typically, whether or not there is a collateral manager in the mix, either the servicer or the special servicer is responsible for processing modifications. However, whether the servicer, the special servicer or the collateral manager is responsible for approving a modification depends on the type of modification at issue.[3]

The default category of modification is what we will call a "Servicing Standard Modification." Servicing Standard Modifications are those that are processed by the special servicer (or, for minor administrative decisions, such as the

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[2] Many of the considerations that come into play when dealing with participations are the same as considerations that come into play when dealing with split notes. For the sake of simplicity, this OnPoint refers to participation agreements and co-lender agreements collectively as "participation agreements."

[3] As noted above, some loans have two or more interests securitized in different CRE CLOs. In these situations, the loan (and each interest in the loan) is serviced pursuant to only one servicing agreement, and only the provisions of the servicing agreement pursuant to which the loan is serviced will be applicable. The governing servicing agreement is typically the servicing agreement for the first CRE CLO in which an interest in the loan is securitized; however, that may not always be the case, and servicing of the loan may shift to other CRE CLOs in the future if the controlling interest is securitized after the non-controlling interest.

decision to grant a waiver of a late payment charge, by the servicer) and it is the special servicer that decides whether to enter into the modification, and what the terms of the modification should be. In making these decisions, the servicer and the special servicer are obligated to act in the best interests of investors and companion participation holders, and must abide by an overarching standard of conduct called the Servicing Standard. The "Servicing Standard" generally requires the servicer and the special servicer to act according to the following standards:

- The servicer and the special servicer must act in accordance with the higher of the following standards: (1) with the same care and skill with which it services and administers comparable assets for third parties (giving consideration to the standards and practices of other commercial real estate servicers); and (2) with the same care and skill with which it services and administers comparable assets owned by the servicer or the special servicer itself; and, in either case, exercising reasonable business judgment and acting in accordance with applicable law, the terms of the servicing agreement and the terms of the loan documents.

- For performing loans, the servicer and the special servicer must act with a view to the timely recovery of all payments of principal and interest, including balloon payments, of the loans. For specially serviced loans and REO properties, the servicer and the special servicer must act with a view to the maximization of recovery of principal and interest on the loan to the parties with an economic interest in the loan.

- The servicer and the special servicer must act without regard to any conflicts of interest it may have arising from (1) its relationships with borrowers, (2) its ownership of CRE CLO security, (3) its right to receive compensation on the loans, (4) its ownership, servicing or management of any other asset or (5) its obligation (or its affiliates' obligation) to repurchase a loan or pay an indemnity in respect of a loan.

As long as the special servicer determines that the Servicing Standard is satisfied, it has significant latitude to modify the loan, limited only by a narrow set of express limitations such as a maximum extension period and a restriction on substitution or release of collateral.[4]

Many CRE CLO servicing agreements contain a provision generally to the effect that the collateral manager may direct the special servicer as it relates to any issue of modification or administration of a loan; however, the special servicer may "override" that direction if it determines that it would result in a violation of applicable law, the terms of the loan documents or would violate the Servicing Standard. The effect of this direction is that, instead of determining whether a modification would satisfy the Servicing Standard, the special servicer is required to process the modification unless it believes that it would not comport with the Servicing Standard.

But the collateral manager may direct certain modifications that are not subject to a Servicing Standard analysis. The nomenclature for this universe of non-Servicing Standard Modifications will vary from one transaction to another, and the specifics are highly negotiated from one transaction to another based on rating agency, underwriter and investor preferences. Generally speaking, there are two types of non-Servicing Standard Modifications. The first type includes "Administrative Modifications," which are generally more routine in nature. Specifics will vary widely from one transaction to another, but Administrative Modifications commonly include modifications to exit, extension and

[4] Certain actions may constitute "major decisions" under the servicing agreement, with respect to which the special servicer is required to obtain the consent of the Controlling Holder (typically an affiliate of the collateral manager) pursuant to a more formalized process. However, in many transactions, Administrative Modifications and Criteria-Based Modifications do not constitute "major decisions."

prepayment fees, yield and spread maintenance provisions, financial covenants, reserve account balances and purposes (except for tax and insurance reserves), interest rate floors and future advance conditions.

The second type includes "Criteria-Based Modifications" (sometimes called "Significant Modifications") which are more substantive in nature than Administrative Modifications and will typically require special criteria to be satisfied. Again, specifics will vary, but Criteria-Based Modifications will generally include modifications such as a change of interest rate, increases in principal balance, delays in payment of principal, change in maturity date, and permission for the borrower to incur mezzanine debt or additional preferred equity. Because these modifications are more substantive than Administrative Modifications, their consummation requires the satisfaction of certain additional conditions, which vary from deal to deal and which differ depending on the type of modification being performed, but typically include some type of cap on the maximum number of modifications permitted over the life of the CRE CLO, compliance with eligibility criteria applicable to newly acquired assets, satisfaction of certain note protection tests (discussed in more detail below), confirmation or deemed confirmation that the rating agencies will not downgrade the ratings on the CRE CLO securities and an obligation to obtain an updated appraisal of the property.

If a modification constitutes an Administrative Modification or a Criteria-Based Modification, then the collateral manager may bypass the Servicing Standard and either direct the special servicer to execute it without further review or analysis, or in certain transactions, the collateral manager may do so itself. So long as the special servicer agrees that the modification at issue is, in fact, an Administrative Modification or a Criteria-Based Modification, the special servicer is required to do so.

But Administrative Modifications and Criteria-Based Modifications are not get-out-of-jail-free cards. *First*, unlike Servicing Standard Modifications, Administrative Modifications and Criteria-Based Modifications can only be performed on loans that are not credit-risk loans,[5] specially serviced loans or Defaulted Loans (as defined below). *Second*, in managed CRE CLOs, the collateral manager must direct these modifications in accordance with the "Collateral Management Standard," a standard of conduct that requires the collateral manager to perform its obligations without regard to any conflicts of interest to which it may be subject, and to exercise a degree of skill and attention no less than that which it (1) exercises with respect to comparable assets that it manages for itself, and (2) exercises with respect to comparable assets that it manages for others, and in either event, in a manner consistent with practices of other reasonable and prudent managers of similar assets. The Collateral Management Standard balances the interests of investors and the collateral manager by allowing the collateral manager more flexibility in matters related to asset management, while ensuring that the collateral manager is serving the interests of investors in performing its duties. *Third*, in the case of Criteria-Based Modifications, they are only acceptable on the conditions that there is no event of default occurring under the CRE CLO, and the Note Protection Tests are satisfied (as described below).

Implications for Note Protection Test Compliance

Certain modifications may have structural consequences, and those consequences can be significant. For example, CRE CLOs feature "Note Protection Tests," which collectively consist of an "Interest Coverage Test" and a "Par Value

[5] Typically, CRE CLO transaction documents will include a category of assets called "Credit Risk Collateral Interests," "Impaired Collateral Interests" or a similar term. The precise definition will vary from one transaction to another, but the term is intended to capture loans that may not necessarily be in default, but are at risk of default or with respect to which default is foreseeable. We will refer to this category of assets as "credit-risk" in this OnPoint.

Test."[6] These tests measure the interest and principal on the collateral available to support interest and principal payments on the CRE CLO notes, and penalize the issuer if those thresholds are breached. If either of the Note Protection Tests are not satisfied, then until that failure is cured, the issuer will lose its ability to purchase new collateral, and interest distributions on the securities retained by the sponsor-affiliate will be redirected to pay down the offered notes.

The "Interest Coverage Test" generally provides that the difference between (1) the sum of (a) expected scheduled interest payments on the assets (other than those that have been defaulted for a certain period of time), (b) cash on deposit in certain accounts and (c) interest advances on the notes, in each case, net of taxes and fees to be paid at the top of the waterfall, and (2) scheduled and defaulted interest on the offered notes, may not fall below a certain threshold (which is typically 120%). But when considering loan modifications, the Par Value Test is far more important, and to explain how it works, we must traverse a web of defined terms.

Generally, the "Par Value Test" estimates the ratio of the principal balance of the collateral to the principal balance of the offered notes, and discounts the numerator if certain events occur that tend to diminish the credit quality of the collateral. The numerator of the Par Value Test is referred to as the "Net Outstanding Portfolio Balance," which is the sum of the amount of cash and the balance of all assets and investments in the CRE CLO; however, for any assets that are "Modified Loans" or "Defaulted Loans," a discount is applied in the form of the "Calculation Amount." The definition of "Calculation Amount" discounts the principal balance of each Modified Loan and Defaulted Loan in order to penalize the issuer for the decreased credit quality of those assets, and to give consideration to the lower likelihood of full realization. For Modified Loans, the asset is discounted based on any appraisal reduction amount that is allocated to the asset, which is typically 90% of the appraised value of the property (based on a recent appraisal), plus amounts on deposit in reserves (other than reserves for taxes and insurance) and any insurance or casualty proceeds or condemnation awards. For Defaulted Loans, the Calculation Amount is more punitive, and the asset is discounted based on the most significant of (1) the appraisal reduction discount, (2) the estimated market value of the asset and (3) the Moody's Recovery Rate of the asset. The "Moody's Recovery Rate" is a fixed percentage based on the type of property securing the asset, and will typically be the most punitive of the three options. For example, loans secured by multifamily properties are discounted to 60% of principal balance, and loans secured by hospitality properties are discounted to 45% of principal balance.

An asset becomes a "Defaulted Loan" if a monetary default or material non-monetary default has occurred on the underlying loan and has continued for more than 60 days.[7] An asset becomes a "Modified Loan" if a modification has any of the following effects:

1. a materially adverse reduction of, or delay in, the amount or timing of any payment of principal or interest;

2. a release of the lien of the mortgage on any material portion of the property without a corresponding principal prepayment of the fair market value of the released parcel; or

3. the special servicer determines the modification materially impairs the value of the security for the loan or reduces the likelihood of timely payment of amounts due.

[6] The "par value test" is often colloquially referred to as an "overcollateralization test" or an "OC test."

[7] In certain transactions, the "Defaulted Loan" definition may be triggered immediately upon a balloon default.

Administrative Modifications and certain COVID-19-related forbearances will typically be carved out of the definition of "Modified Loan" given the relatively routine nature of these modifications, and transactions are split as to whether a Criteria-Based Modification can cause an asset to become a "Modified Loan."

So, when calculating the Par Value Test, issuers are penalized for Modified Loans in the pool that suffer an appraisal reduction,[8] and will be penalized significantly for any Defaulted Loans, which means that it is in the best interest of every issuer to minimize the amount of Modified Loans and Defaulted Loans in the pool at any given time. Generally, it is advisable to structure loan modifications in such a way that does not require the special servicer to make a "Modified Loan" determination (*i.e.*, by use of Administrative Modifications and, in some transactions, Criteria-Based Modifications). However, if a "Modified Loan" analysis is required, the collateral manager should take care to avoid an impairment that would materially reduce or delay principal or interest payments (or any other impairment that would cause the asset to become a Modified Loan), and the collateral manager should communicate expectations with the special servicer and come to an agreement as to whether the modification would cause the loan to become a Modified Loan.

Rating Agencies and Investors

Rating agencies perform ongoing surveillance of the CRE CLO after closing. Some modifications may require express (or deemed) confirmation from one or more rating agencies that the ratings on the CRE CLO notes will not be downgraded as a result of the modification. These modifications typically include increases in the principal balance of the loan, waivers of due-on-sale or due-on-encumbrance clauses for loans that exceed certain size-related thresholds and substitution of collateral. In addition, rating agencies will prepare periodic surveillance reports for investors summarizing the performance of the CRE CLO and may discuss certain modifications performed during the reporting period.

Investors also closely scrutinize loan modifications. Modifications are reported by the servicer in its monthly reporting, which is posted on a monthly basis on the investor website maintained by the note administrator. Because investors care about the details around loan modifications, a prudent collateral manager should consider not only whether the modification is permissible under the governing agreements, but whether the modification would be objectionable to investors. A modification that raises investor eyebrows can cause more than just a headache; it can cause reputational damage and increased scrutiny on future issuances, and in worst case scenarios, could raise the specter of litigation. In short, just because you *can* modify a loan, doesn't mean you *should*.

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In summary, when modifying a loan in a CRE CLO, there are several factors to consider, including, among others:

- Which party is responsible for making the ultimate decision concerning the modification;
- Which stakeholders have consent or consultation rights with respect to the modification;
- Whether the modification will have adverse implications for Note Protection Test compliance; and

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[8] However, Modified Loans may not have adverse consequences on Note Protection Test compliance if there is no appraisal reduction amount.

- Whether the modification will present other reputational issues.

When All Else Fails

Sometimes, loans just go bad. Issuers always have the option to hold onto distressed assets and work them out inside the CRE CLO structure, provided that they are willing to accept the consequences that decision may have on their compliance with the Note Protection Tests. But if not, then collateral managers (and their affiliates) still have a few tools in their toolboxes. Below, we identify the two most important ones.

1. Sales and exchanges. Typically, if a loan is a Defaulted Loan or is otherwise credit-risk, the collateral manager may direct the issuer to sell the loan or exchange it for a performing asset. In fact, the CRE CLO is structured to give the collateral manager every incentive to do just that (for example, the Note Protection Tests). Credit risk/defaulted sales require a sponsor-affiliate (or a third party) to have liquidity sufficient to pay the purchase price and put the asset on its own balance sheet, but there are numerous benefits. *First*, balance sheet workouts are far simpler to perform. Workouts of securitized products are complicated by compliance with the various transaction documents, but balance sheet workouts are limited only by the lender's own willingness to perform a modification. *Second*, the loan does not count for purposes of Note Protection Test calculations. *Third*, investors generally appreciate collateral managers that are willing to protect the CRE CLO from losses, and collateral managers generally try to do so whenever possible for reputational reasons.

Credit risk/defaulted sales are far more common than exchanges, but exchanges have become increasingly popular. Exchanges permit the collateral manager to replace the underperforming loan not with cash, but with another asset. Exchanges can be performed even when the CRE CLO is outside of its reinvestment period, so long as the asset being exchanged satisfies the eligibility criteria applicable to all newly acquired assets. The ability to exercise this option outside of the reinvestment period, together with the benefits of not having to put up cash to purchase the under-performing asset, makes credit risk/defaulted exchanges an increasingly popular option in a world of limited liquidity.

2. Contributions. Most CRE CLOs, whether static or managed, permit the parent of the issuer to contribute cash and eligible investments to the issuer at any time. In managed CRE CLOs, the parent of the issuer also typically has the option to contribute assets that satisfy the applicable eligibility criteria at any time. Unlike a sale, the consideration for the contribution is not cash, but rather, a corresponding increase in the value of the parent's equity interest in the issuer. The issuer will get credit for any contributed collateral for purposes of the Note Protection Tests. This can be effective to prevent early amortization of the CRE CLO or to preserve the ability to reinvest (if the CRE CLO is still in its reinvestment period).

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Both bridge loans and CRE CLOs are individually tailored to the needs and interests of the relevant parties, and each one is different. The circumstances surrounding any loan modification will necessarily be informed by the particular details of the applicable loan documents, servicing agreement, indenture, participation agreements and repurchase agreements, each of which will typically be highly negotiated, in addition to various other legal, tax, accounting and commercial considerations. If you would like to discuss CRE CLO modifications and workouts, please contact one of the Dechert attorneys listed below or any Dechert attorney with whom you regularly work.

The information in this OnPoint does not, and is not intended to, constitute legal advice. The information in this OnPoint is presented for general informational purposes only. You should contact your attorney to obtain advice with respect to any particular legal matter.

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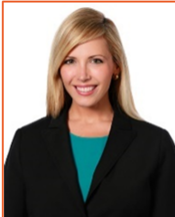

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