Knowledge is power: Accessing loan information in troubled CMBS

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If the days of "extend and pretend" actually come to an end for commercial real estate loans this year, there will be a greater focus on investors' rights to information regarding troubled properties. Valuation issues have received much of the attention recently, but it is the information underlying valuations and matters such as borrower performance and a loan's restructuring prospects, that would enable investors to understand their position and minimize exposure . . . if they can access it.

In 2023, numerous commercial real estate loans comprising billions of dollars of principal supporting commercial mortgage-backed securities (CMBS) were transferred to special servicers, which administer loans in default. That trend is expected to intensify due to continued interest rate pressure and high vacancy rates, especially in the office sector.

CMBS investors should thoroughly familiarize themselves with the specific information flows pre- and post-default under their deals. Not all PSAs (pooling and servicing agreements) are alike, and deal parties possessing loan information are likely to favor strict adherence to the contractual terms of the PSA relating to any disclosure obligations to certificateholders.

Information flows prior to default

Prior to a loan entering default and its transfer to special servicing CMBS investors enjoy significantly more access to information. While a borrower remains current on payments, the Master Servicer appointed under the PSA will service the performing loan.

The Master Servicer, as the initial recipient of most of the ongoing loan-level information that the borrower is required to provide to deal parties, typically then provides the information to a Certificate Administrator. The Certificate Administrator, in turn, compiles the trust and loan information it receives from various sources to create a monthly distribution report that is made available to investors.

Information about trust performance and the underlying loans is generally available to essentially all classes of registered certificateholders, though distribution is still sometimes subject to deal- or party-specific limitations.

Once a CMBS loan enters default, however, the information flow changes. Servicing responsibility shifts from the Master Servicer to a Special Servicer, which begins formulating a plan with the defaulted borrower to address rehabilitation of the loan for the controlling certificateholders' review.

Servicing transfer event triggers

PSAs identify various types of defaults as "servicing transfer events" that require a Special Servicer to take over servicing responsibilities. Typically, these events relate to payment defaults and are triggered when a borrower does not bring a loan current within a specified amount of time, or, in the case of a maturing loan, if the borrower cannot pay the loan in full and does not have a refinancing plan. Events that materially impair the value of the borrower's property may also trigger a servicing transfer.

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Monthly distribution reports will include notices about these events, as well as basic reporting information about the default and the actions of the Special Servicer.

The servicing standard for special servicers

The Special Servicer must administer the default resolution process according to a defined "servicing standard" under the CMBS PSA. This standard generally requires the Special Servicer to manage the defaulted loan for the collective interests of all certificateholders in the same manner in which it services comparable loans owned by third-parties or for its own account and in accordance with customary industry practices.

The Special Servicer must exercise its duties and maximize recoveries without regard to potential conflicts of interest stemming from its relationship with any parties to the trust or related loans.

Following a default, disputes may arise over the Special Servicer's assessment of the borrower's ability to repay the loan, the current valuation of the property, the effect of the valuation on control rights, and the rights to distributions under PSA provisions. To assess potential claims relating to these issues, as well as the Special Servicer's adherence to the servicing standard, deal parties will want to obtain as much information as possible regarding the defaulted loan.

Default loan information for the controlling certificateholders

After a servicing transfer, the Special Servicer prepares an Asset Status Report that discloses information it receives regarding the delinquent loan and provides a plan of action for the controlling certificateholders to review.

These certificateholders, representing holders of the first loss certificates, are entitled to receive the most information because they bear the greatest risk of loss in the event of default. Barring an appraisal reduction amount that requires shifting control, they hold the power to determine what steps the Special Servicer should take to bring the loan out of special servicing.

As for non-controlling certificateholders, some PSAs block their access to non-final versions of the Special Servicer's report and will provide such holders access only to a summary of the final version approved by the controlling certificateholders.

This information disparity can create conflict between certificateholders that are not in a control position but likely still have an interest in fully evaluating their continuing rights under the terms of the trust while a loan is specially serviced. Agreements governing CMBS trusts address this potential information disparity to varying degrees.

Default loan information for non-controlling certificateholders

Non-controlling certificateholders that are not afforded unfettered access to the Asset Status Report or that seek documentation regarding a defaulted loan before the Special Servicer's plan is accepted or rejected by controlling certificateholders, will need to review the PSA for any rights to underlying documents obtained by the Special Servicer during the process of its review of the defaulted loan.

Such information may include an updated appraisal of the defaulted property and information regarding its future prospects, such as operating statements, rent rolls, and financial statements. Some PSAs contain provisions that allow a non-controlling certificateholder to request copies of these materials from other deal parties, like the Master Servicer, in order to assess its ongoing interests in the trust.

These underlying materials are likely essential to any challenge a non-controlling class certificateholder may want to bring relating to actions of the controlling certificateholders or Special Servicer. A proactive certificateholder will want to examine all avenues available for obtaining such information under relevant PSA provisions.

Where the PSA does not explicitly provide for information sharing, certificateholders may consider alternatives under their PSA that may allow them to uncover vital information regarding a default. For example, there may be provisions that grant certificateholders holding a requisite percentage of voting interests a right to request the Trustee or other deal party to investigate aspects of reports relating to a default.

An additional path to exert pressure on a Special Servicer could be to request that the Special Servicer provide additional information to Ratings Agencies (which may be allowed or required to receive additional information about defaulted loans in a trust) so that such agencies can assess whether the Special Servicer is adhering to the servicing standard.

Conclusion

CMBS investors should take the time now to understand information flows and their rights to information. Being aware of which parties are in control of information and their obligations under varying circumstance will help set expectations for the future and develop strategies to obtain the materials needed when the time comes to take action.

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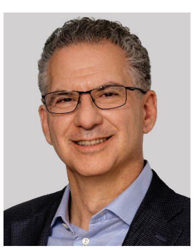

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