

**Agency Risk in CMBS Default Resolution – A Case Study of the Peter Cooper Village – Stuyvesant  
Town Mortgage Loan Default**

**by**

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**Submitted to the Program in Real Estate Development in Conjunction with the Center for Real  
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**ABSTRACT**

Between 2010 and 2018, approximately \$410 billion of maturing CMBS loans are expected not to be able to refinance; that is, they are in high risk of default. The current real estate downturn has not only pushed delinquencies to a historic high but has also inflicted losses to bondholders. When losses are realized through foreclosure, junior bondholders can have the face amount of their investment significantly reduced with no cash payment, while the senior bondholders receive partial repayment of their investment at par. Alternatively, loan modifications, or workouts, yield different outcomes which are more favorable to the junior bondholders. The rising tide of loan defaults and loan workouts will certainly exacerbate the ongoing “tranche war” among the CMBS bondholders. Consequently, it is imperative to understand how the CMBS servicing structure governs default resolution and loan workouts. By analyzing the recent default of Peter Cooper Village-Stuyvesant Town, this study will examine the case of the largest commercial real estate default in the US history as a real life example to illustrate whether the overlapping role of B-Piece buyer and Special Servicer adversely affects workout prudence. Through interviews with industry professionals and a review of the Pooling and Servicing Agreement (PSA), and a review of the transcript of the CMBS Investment Grade Bondholder Forum in June, 2010, the study proposes structural changes that could potentially mitigate agency risk inherent in the current servicing structure.

**Thesis Supervisor: W. Tod McGrath  
Title: Lecturer, Department of Urban Studies and Planning**

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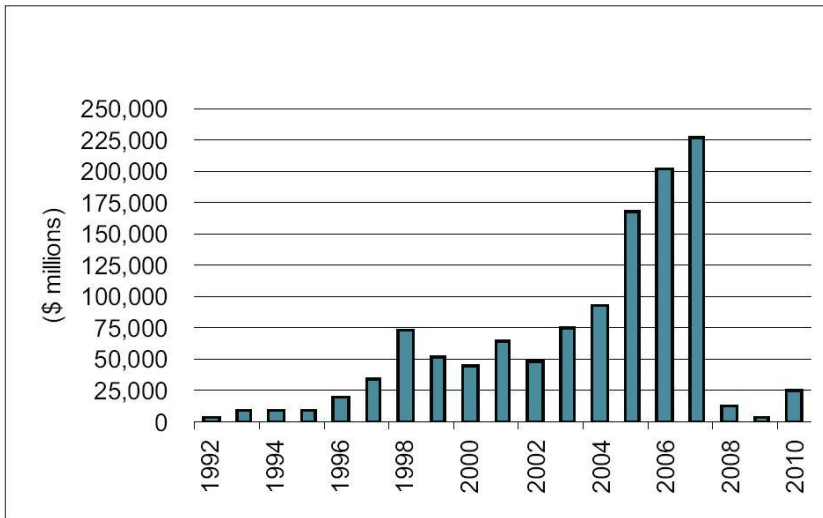
## **Chapter One - Innovation Borne Out of Crisis**

Commercial Mortgage Backed Securities (“CMBS”) are bonds created by securitizing a pool of individual mortgage loans on commercial properties. CMBS are traded in public capital markets. Securitization of mortgages has steadily gained prominence on Wall Street as an effective financing and investment vehicle. For the past decade, CMBS has played a critical role in providing financing liquidity to the real estate industry. Interestingly, this novel debt vehicle was borne by the government during the financial crisis in 1980s as a tool to resolve thrift insolvency.

In response to the financial crisis in the thrift industry in the late 1980s (commonly referred to as the savings and loan crisis), Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The mission of FIRREA was to address the insolvency in the thrift industry. Under FIRREA, the Resolution Trust Corporation (RTC), a federal government corporation, was created to arrange the sale of troubled thrifts and liquidating their assets. Many of these assets consisted of commercial mortgages. Under political pressure to dispose of the troubled assets quickly, the RTC had to devise a block sale program that could generate significant investor interest in the commercial mortgages amid the down market. A typical block of mortgages consisted of a mix of performing and nonperforming loans. With the help of Wall Street analysts and bond rating agencies, the RTC was able to slice the block into tranches and assign a bond rating to each tranche based on the default risk of that tranche. Given investors’ familiarity with the bond rating system, such mortgage bonds were well received by investors with varying risk appetites in the public market. Riding on the success of the RTC, Wall Street subsequently transformed the CMBS market from a bad loan liquidation pool into a debt financing market by-choice.

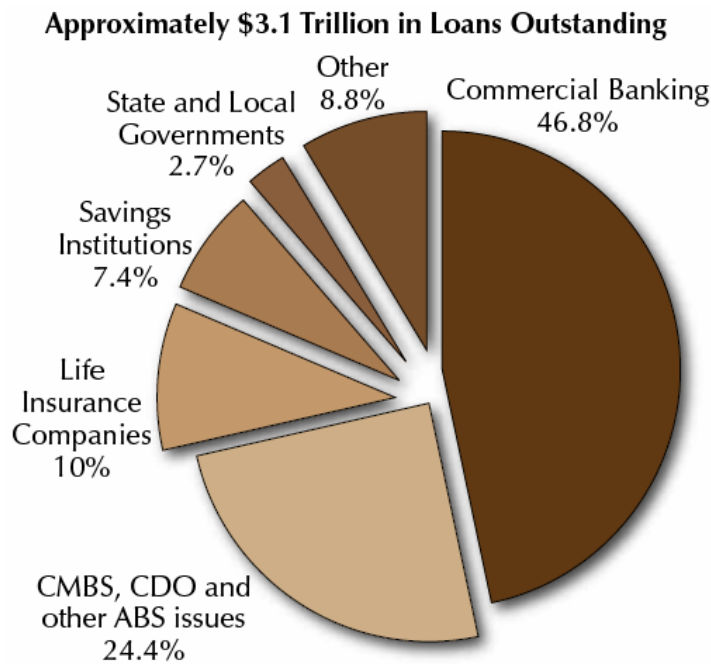
Figures 1 and 2 below show the annual issuance of CMBS by dollar volume from 1992 to 2010, and the current market share of CMBS in the US commercial real estate debt market.

**Figure 1 Historical & Projected CMBS Issuance**



Source: Commercial Mortgage Alert

**Figure 2 Commercial Real Estate Debt Capital Sources, 2010**



Source: Mortgage Bankers Association (courtesy of Real Estate Roundtable)

## Chapter Two - State of the Market

July 2010, this country is approaching the third anniversary since the subprime mortgage crisis unraveled. Hovering around 10,000, the Dow has fallen from a historic high of 14,000 in October 2007 to a 12-year low of 6,550 in March 2009. The subprime mortgage crisis not only touched off a global credit crunch but also permanently redrew the landscape of Wall Street. At the height of the crisis, Lehman Brothers, the 158-year old investment bank with \$600 billion in assets, filed for Chapter 11 bankruptcy protection. The federal government was forced to inject the economy with a \$700 billion stimulus and acquire majority ownership in American International Group, Inc. (AIG), a bellwether in the global insurance industry and once the 18th-largest public company in the world, to avert an economic meltdown. The CMBS market came to a complete halt and remained frozen for months. Five of the top 10 commercial mortgage-backed securities (CMBS) originators were either acquired by competitors or became bankrupt. Figure 3 shows the top 15 CMBS originators before the crisis.

**Figure 3 Major CMBS Originators before the Subprime Mortgage Crisis**

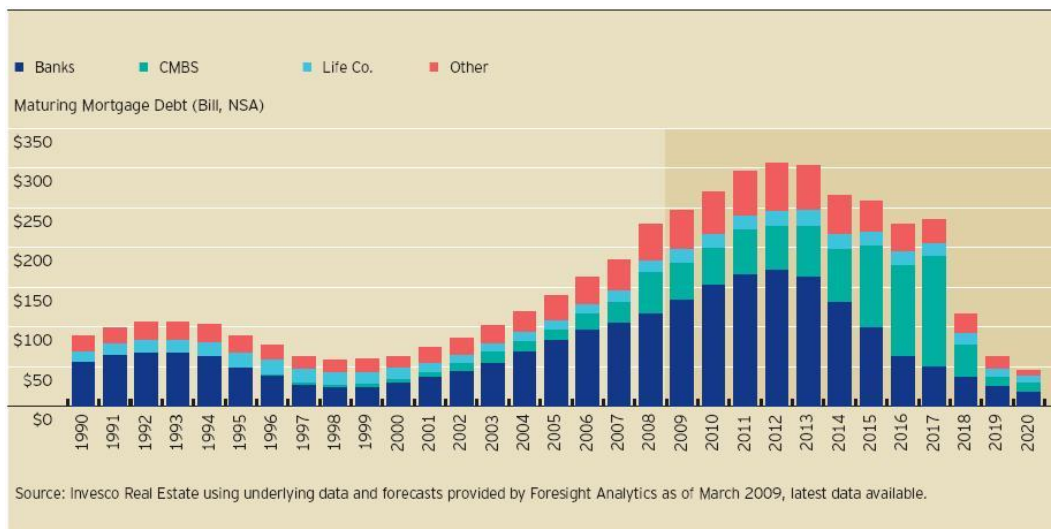
Rank	Loan Contributor	CMBS Loans (In Billions)	Write-downs (In Millions)	Status of Bank
1	Wachovia	\$62.3	\$2,290.0	Acquired by Wells Fargo
2	Bank of America	\$47.5	\$2,255.0	Currently originating mortgages
3	Credit Suisse	\$44.2	\$4,998.0	
4	Lehman Brothers	\$35.6	\$4,800.0	Filed for bankruptcy
5	J.P. Morgan	\$35.0	\$1,673.0	
6	Morgan Stanley	\$34.3	(\$600.0)	
7	Deutsche Bank	\$30.8	\$2,618.0	
8	RBS Greenwich	\$24.8	\$441.0	
9	Merrill Lynch	\$24.8	\$2,071.0	Acquired by Bank of America
10	Bear Stearns	\$24.7	\$2,730.0	Acquired by J.P. Morgan
11	Goldman Sachs	\$21.3	\$3,425.0	Currently originating mortgages
12	UBS	\$19.3	\$212.0	
13	Citigroup	\$18.7	\$2,845.0	
14	ABN Amro (LaSalle Bank)	\$15.1	NA	Acquired by RBS Greenwich consortium
15	Countrywide	\$14.3	NA	Acquired by Bank of America
	Top 15 Contributors	\$452.6	75.4%	
	All Other Contributors	\$147.9	24.6%	
	Total of All Contributors	\$600.5	100.0%	

Sources: Credit Suisse, *Commercial Mortgage Alert*  
 \*Total net write-downs reported from 4Q07 to 2Q09

With property values having fallen more than 40 percent from the peak in 2007, commercial real estate is in the deleveraging phase of the market cycle and the volume of distressed properties is climbing towards \$200 billion. Of this \$200 billion, CMBS loans account for about \$81 billion (41%). Standard & Poor's expects the delinquency rate to reach 7%-8% of the outstanding \$806 billion principal balance of U.S. CMBS in 2010. Deutsche Bank projects that at least two thirds of the loans maturing between 2009 and 2018 (\$410 billion) are unlikely to qualify for refinancing at maturity without significant equity infusions from borrowers. For the 2007 vintage financings, well in excess of 80% of the loans are unlikely to qualify. Loans originated during the golden vintage of 2005 to 2007 are most problematic due to their high loan-to-value ratio (LTV), zero principal amortization since origination and markedly lower asset values. This "refinancing crisis" has led to mass extensions and, subsequently, to modifications and liquidations during the next five years. Ultimately, CMBS Trusts will suffer huge losses. Therefore, default resolution and loan workouts are a focal point in the commercial real estate industry today.

Figure 4 below illustrates the maturing loan volume by lender type over a 20-year span.

**Figure 4 Commercial and Multifamily Mortgage Maturities by Lender Type**



Given the structural complexity of CMBS, its loan workout and recovery is more sophisticated and contentious than that associated with portfolio loans. The current real estate downturn is serving as the first stress test to the post-default structural soundness of this innovative and critical debt vehicle since its birth. What's more, the looming "refinancing crisis" and the consequent rising tide of defaults will likely exacerbate the clash between various classes of bond holders. What is considered best for the Trust is not always concurred with by all the bondholders. Quantifying loss variations associated with different workout strategies would enable CMBS participants to better understand the impact of the servicing structure on the default resolution process and the value of the underlying real asset. While quantification of financial losses is relatively straightforward, justification of the servicing standard and so called "best practices" in loan workouts are often elusive and controversial. As pointed out by numerous studies in the past, agency risk is one interesting element in the current servicing structure of CMBS and can often be the flashpoint between the different classes of bondholders during the workout process. Understanding the legal and economic significance that agency risk can pose in loan workouts, this study will examine the workout strategy of the recent Peter Cooper Village – Stuyvesant Township properties, both qualitatively and quantitatively. The objective of this thesis is to demonstrate how agency risk casts implications on workout prudence through the case study of one of the largest commercial real estate default in the US history. Lastly, through literature review and interview with market practitioners, this thesis will offer recommendations that could mitigate the structural deficiencies in the current servicing mechanism.

## **Chapter Three - Overview of CMBS**

### **3.1 Basic**

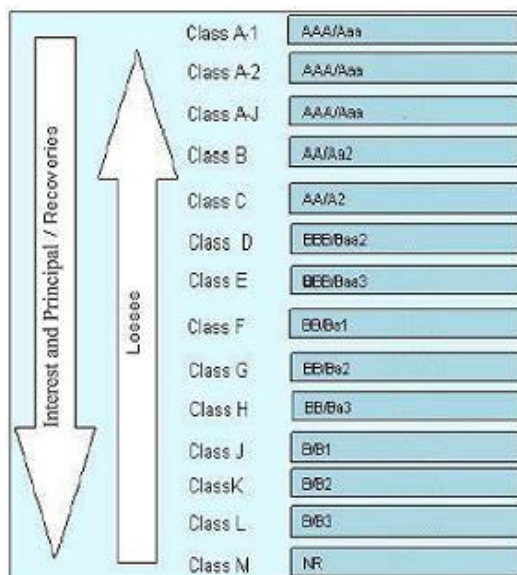
Commercial real estate first mortgage loans can generally be broken down into two main categories: (1) portfolio loans and (2) securitized loans (CMBS). Before the advent of CMBS, the vast majority of loans were portfolio loans. Portfolio loans are held on lenders' balance sheets through maturity. With CMBS, a typical transaction consists of many single mortgage loans of varying size, property type and location. These loans are pooled together and transferred to a Trust. The Trust then issues a series of bonds of varying yield, maturity and payment priority. Such variations in yield, maturity and payment priority constitute different bond classes. The different classes of bonds are known as tranches. Bond rating agencies assign credit ratings to each tranche. These rating agencies are designated as Nationally Recognized Statistical Rating Organizations (NRSRO) by the United States Securities and Exchange Commission. The three major credit rating agencies in the United States are Fitch Ratings, Moody's Investors Service, and Standard & Poor's.

Tranches by credit quality hierarchy typically go from investment grade (AAA/Aaa through BBB-/Baa3) to below investment grade (BB+/Ba1 through B-/B3) and then to the lowest tranche, which is not rated. Investors of varying risk appetite purchase bond(s) of different tranches based on their investment strategy and return expectations. Bonds backed by a pool of loans are generally worth more than the sum of the value of the whole loans because the tranching of securities creates favorable opportunities for price discrimination with respect to different types of investors. Such value creation allows securitized loans to be more aggressively priced.

### 3.2 Waterfall

Interest and principal payments from the pooled loans is paid to the bond investors each month. Investors holding the highest rated bonds are the first to get paid. Once the accrued interest on the highest rated bonds is paid, interest is then paid to investors holding the next-highest rated bonds and forth. Such waterfall structure applies to bond principal repayments as well. In the event of a payment shortfall, investors in the most subordinate bond class will stand first to suffer a loss. Further losses will start creeping up towards more senior classes in reverse order of priority. Institutional investors, insurance companies and pension funds are the typical buyers of the investment grade bonds (senior classes). Investors with high risk tolerance and return expectations will typically invest in the junior or subordinate tranches. These investors are commonly referred as B-piece buyers. The junior tranche or the B-piece has the first-loss position and exposes investors to the greatest credit losses in the event of default on the underlying mortgage loans. Figure 5 below is a graphical representation of payment and loss hierarchy in a typical CMBS offering.

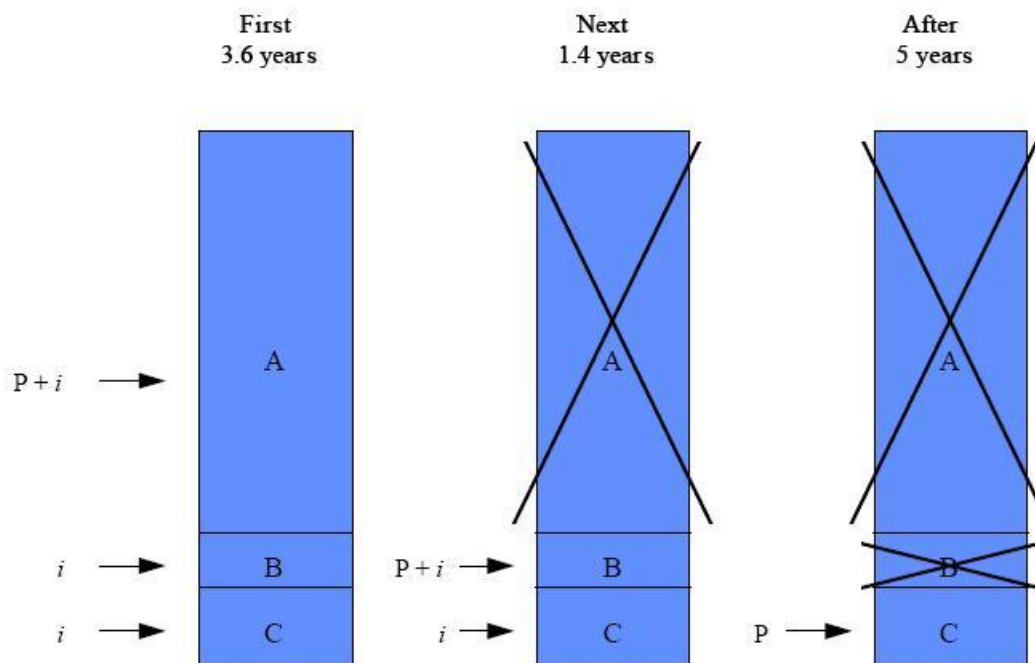
**Figure 5 Typical CMBS Payment and Loss Hierarchy**



Source: Commercial Real Estate Finance Council

Class A-1 is often called the “Super Duper Senior” because this class has the highest credit rating (AAA) and also has the very first claim priority in the Trust. Class A-2 is the Super Senior or Mezzanine AAA class and Class A-J is Junior, the most subordinated AAA class. Class M is the unrated tranche or the B-Piece. Exhibit 6 illustrates how a sequential waterfall distributes payments to the bondholders. Assuming that all mortgages pay off fully and on time, senior class bondholders (Class A) will receive interest and principal payments while the junior classes (Class B and C) will receive only interest payments during the initial 3.6 years. When Class A bondholders have received all interest and principal payments in full, Class A will be retired. For another 1.4 years, Class B bondholders begin to receive interest and principal payments while Class C bondholders still receive only interest payments. Upon the retirement of Class B, Class C bondholders will receive the remaining principal balance outstanding. Figure 6 below illustrates how payment is distributed to bondholders with respect to claim priority.

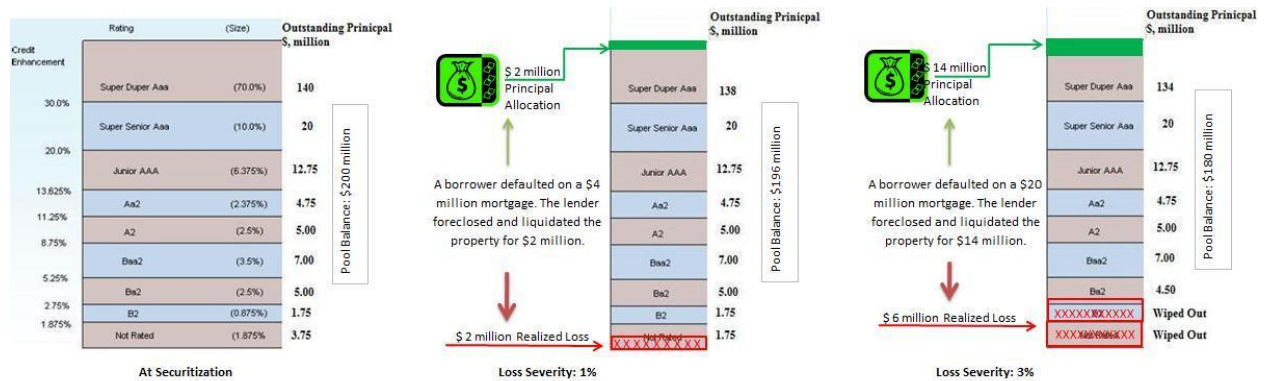
**Figure 6 Sequential Payment Waterfall**



Source: Commercial Real Estate Finance Council

The diagram below demonstrates how different loss severities affect bondholders' positions.

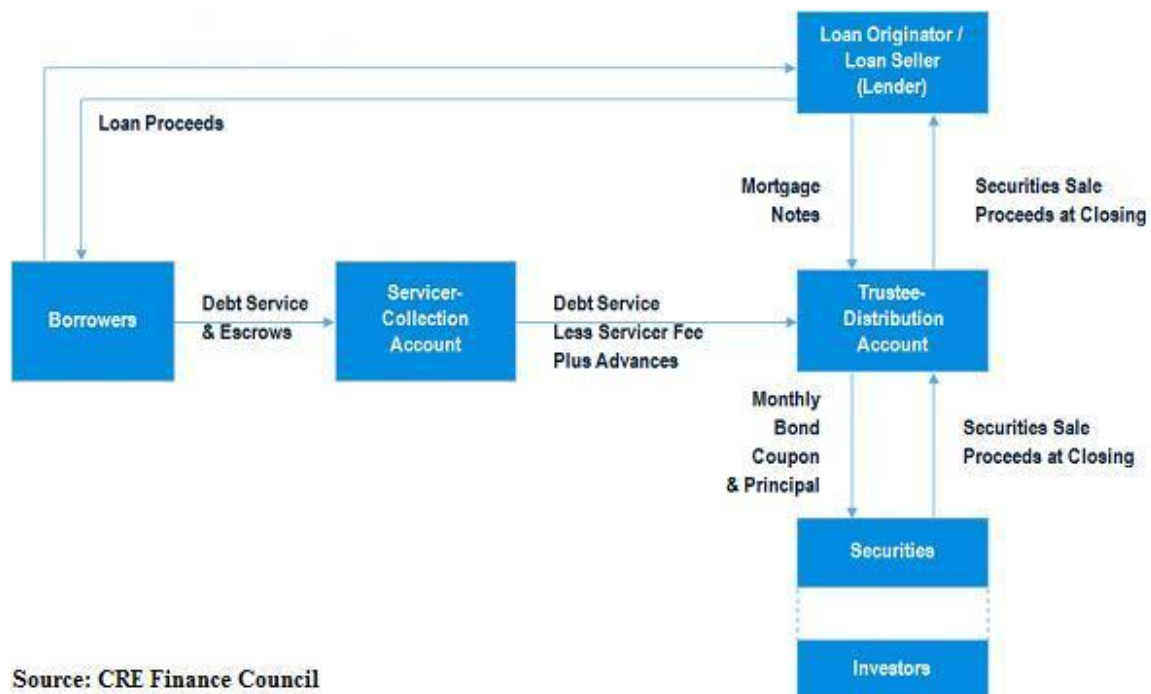
**Figure 7 Loss Allocation**



Base map source: CRE Finance Council

### 3.3 How money flows

With respect to debt collection and payment distribution, CMBS has more structural layers compared to portfolio loans. The following chart shows a typical “money flow” from borrowers to CMBS investors/bondholders.



Source: CRE Finance Council

### 3.4 Key Participants

A typical CMBS transaction would entail the following functional entities:

- Master Servicer
- Special Servicer
- Directing Certificate holder/ Controlling Class/ B-Piece Buyer
- Trustee
- Rating Agencies

#### **Master Servicer:**

The Master Servicer is charged with servicing the loans in the pool through maturity and interacting with borrowers who are not in default. The Master Servicer is responsible for collecting the payments from borrowers, holding and making any disbursements from escrows, and performing most routine loan administration functions. In addition to periodic property inspection, the Master Servicer analyzes rent rolls, operating statements and other financial and property information.

#### **Special Servicer:**

Once a default occurs, the administration of the loan is transferred to the Special Servicer.

Specialized in dealing with defaulted mortgage loans, the Special Servicer is usually appointed by the Directing Certificateholder (see next section for definition). Often times the Special Servicer is an affiliate of the Directing Certificate holder which creates agency risk, which is discussed below. Like the Master Servicer, the Special Servicer has a duty to the Trust and is subject to the serving standard. The servicing standard mandates that the Special Servicer must act to maximize the recovery on the mortgage loan to the Trust based on an analysis of collection alternatives using a net present value methodology. The Special Servicer can consider multiple alternatives as part of its analysis, including loan modification, foreclosure, deed-in-lieu, negotiated payoff or sale of the defaulted loan. The Directing Certificate holder can often direct

the Special Servicer's actions with respect to defaulted loans provided the Servicing Standards are adhered to.

**Directing Certificateholder/ Controlling Class / B-Piece Buyer:**

B-Piece Buyers generally purchase the B-Rated and BB/Ba-rated bond classes along with the unrated class. Compared to investment grade bond buyers, B-Piece buyers are risk takers and are aggressive in both their due diligence and investment strategies. The most subordinate bond class outstanding at any given point is considered to be the Directing Certificateholder, also referred to as the Controlling Class. Given that actual losses on the underlying mortgage loans are charged against the lowest rated bonds, the Directing Certificateholder is given the opportunity to play an active role in monitoring the performance of each loan, make decisions on key asset issues and appoint and/or terminate the Special Servicer.

**Trustee:**

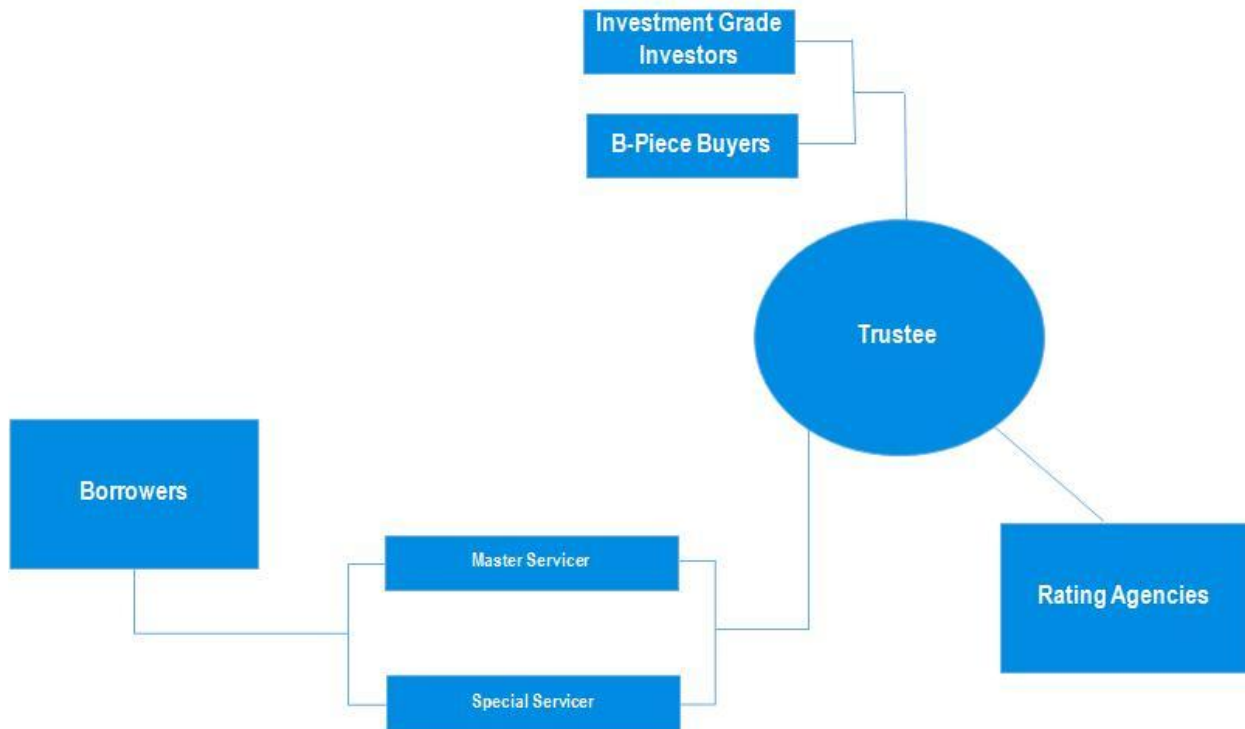
The Trustee holds the loan documents and distributes payments from the Master Servicer to the bondholders. The Trustee typically delegates loan management authority to either the Master or the Special Servicer. Since the Trustee holds the loans, it will be named in enforcement actions. In most instances, the Trustee is acting by and through either the Master Servicer or the Special Servicer.

**Rating Agencies:**

Besides assigning credit ratings to the bonds, the rating agencies also monitor the ongoing financial performance of the mortgage loans. Delinquencies and potential credit loss events could trigger a downgrade of any of the bond class ratings by credit rating agencies.

The diagram below shows the structural relationship between the participants.

**Figure 8 CMBS Post-Securitization Participants**



### **Pooling and Servicing Agreement**

Pooling and Servicing Agreement or PSA defines the management structure of the mortgage pool. The PSA contains extensive detail governing the duties of the servicers in managing the loans and allocating cash flows to different classes of investors. The PSA protects the REMIC (see below) status and resulting tax treatment of the Trust, and balances the conflicting interests between classes of bondholders, and those of the issuer, servicers, and others. The usual parties to this agreement are the Trustee and the Custodian for the Trust holding the mortgages, a Master Servicer, and a Special Servicer.

**REMIC**

REMIC stands for Real Estate Mortgage Investment Conduit. It is a typical special purpose vehicle defined under the United States Internal Revenue Code (Tax Reform Act of 1986) for pooling mortgage loans and issuing mortgage-backed securities. The Tax Reform Act of 1986 eliminated the double taxation of income earned at the corporate level by an issuer and dividends paid to securities holders, thereby allowing a REMIC to structure a mortgage-backed securities offering as a sale of assets, effectively removing the loans from the originating lender's balance sheet, rather than a debt financing in which the loans remain as balance sheet assets. A REMIC itself is exempt from federal taxes, although income earned by investors (bondholders) is fully taxable. As REMICs are typically exempt from tax at the entity level, they may invest only in qualified mortgages and permitted investments, including single family or multifamily mortgages, commercial mortgages, second mortgages, mortgage participations, and federal agency pass-through securities.

### 3.5 Governance and Servicing Structure

Agency risk in the servicing structure of CMBS has been identified in numerous publications for more than a decade. However, it is the extraordinary loss severity and intensifying “tranche warfare” during the current real estate downturn that is prompting greater attention from CMBS constituents. To pin point the agency risk and its implications on workout prudence, one must understand the servicing structure of a CMBS Trust. Reviewing existing literature on the topic paints a very interesting mix of theoretical and practical issues relating to the servicing structure.

In general, the Special Servicer takes over the servicing responsibility of a loan once it is delinquent for 60 days. The Special Servicer could work with the borrower to bring the loan current, or declare a default. If the loan is brought current, it can then be returned to the performing asset pool managed by the master servicer. Regarding default resolution, the Special Servicer has wide latitude in choosing workout alternatives. The alternatives were summarized in an earlier study by Jacob [2004]<sup>1</sup> and consist of the following:

- Foreclosure;
- Modification or waiver of a monetary term, including the timing of payments, or any material non-monetary term;
- Any proposed sale of an REO<sup>2</sup> Property out of the Trust for less than the outstanding principal balance;
- Any acceptance of a discounted payoff with respect to a specially-serviced mortgage loan;

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<sup>1</sup> (Darling, 2004)

<sup>2</sup> Real estate owned or REO is a class of property owned by a lender after an unsuccessful sale at a foreclosure auction.

- Any release of collateral or acceptance of substitute collateral for a mortgage loan in the Trust;
- Any release of “holdback”, earn-out, or performance reserve funds, or return of any related letter of credit delivered in lieu of such reserve funds, to the borrower under any pooled mortgaged loan;
- Any waiver of a due-on-sale or due-on-encumbrance clause; and
- Any acceptance of an assumption agreement releasing a borrower from liability under a pooled mortgage loan.

Pursuant to the Servicing Standard, the Special Servicer is obligated to recover the most value from the non performing loan on behalf of the Trust. So exactly what is the Servicing Standard?

The Servicing Standard is a standard of conduct to which the servicers are obligated. The

Servicing Standards consists of four essential principles<sup>3</sup>:

1. **Standard of Care:** The Servicer must act in accordance with the higher of (i) the standard of care it applies to loans held for its own account and (ii) the standard it applies to servicing loans held by third parties (giving due consideration to customary practices of prudent institutional commercial mortgage lenders).
2. **Collective Whole:** The Servicer must take into account the interests of all certificate holders, as a collective whole.
3. **Timely Recovery on a Net Present Value Basis:** The Servicer must service the loan with a view to the timely collection of all principal and interest payments or, with respect to a loan in default, the maximization of recoveries on such loan on a net present value basis.
4. **Conflicts:** The Servicer must service the loan without regard to conflicts of interest, such as other business relationships with a borrower, ownership of certificates in the securitization, or any subordinate or *pari passu* debt relating to a loan in the securitization, any obligation to make advances on any of the loans, the right of the Servicer to be paid, or the ownership or servicing of loans or properties outside of the securitization pool.

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<sup>3</sup> (Dechert LLP, 2010)

A seemingly simple and unambiguous standard can in fact be quite tricky when it comes to execution.

“Fitch has concerns when the interpretation of documents benefits the special servicer only, allowing them to take no risk with their own capital and potentially creating expenses to the Trust. Fitch is aware of situations where it appears the special servicer has availed themselves of the legal system too readily, when it was not warranted and done at the expense of the Trust.”<sup>4</sup>

Unlike corporate debt restructurings, the senior debt holder in a CMBS Trust takes a back seat during a default resolution. The workout right or power lies with the junior debt holder who is either the Special Servicer itself or the junior debt holder can appoint a special servicing agency. Such a unique servicing mechanism is based on the commonly agreed notion that a combination of better asset level information and the “first-loss” nature of the junior security holder make it the most effective controller of special servicing issues.<sup>5</sup> It is this very “first loss” position that incentivizes the junior security holder to work most earnestly to salvage the maximum ex-post value from the asset for themselves. It is argued that the best interest of the junior security holder is in lockstep with that of all other security holders in the Trust. Coupled with their better evaluation and transaction skills, the junior security holder is believed to be the most prudent participant to conduct a loan workout. In both theory and practice, such servicing mechanism trumps the typically contentious corporate debt restructuring where the senior’s gain is usually at the expense of the junior debt holder.

The same studies that support the above theory would also point out that such servicing mechanism is prone to agency risk. The agency risk stems from the marriage of the default resolution authority and the “first loss” junior debt holder.

“Dissent among the bondholders in various classes and between bondholders and servicers has been a characteristic of the CMBS market since its inception. While

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<sup>4</sup> (Fitch Warns U.S. CMBS Special Servicers: Play Fair or Else, 2003)

<sup>5</sup> (Darling, 2004)

competing claims can act as a system of checks and balances, they often create conflicts as each participant has their own objective based on their position in relation to the transaction.”<sup>6</sup>

In a default, the AAA investor or senior debt holder would mostly prefer a “quick exit”. With “credit support” or a “subordination buffer” provided by the junior debt holders, senior debt holders can usually escape unscathed. On the opposite end, the junior security holder inevitably likes to extend the loan to get more time to stay alive in order to increase the probability of getting its investment repaid. Such investment repayment from loan extension may result in an ex-post wealth transfer from the senior security holder to the junior security holder.<sup>7</sup>

A majority of quantitative studies on default resolution appears to reinforce that the special servicer has a higher proclivity to “wait out” a default situation in hopes of a correction down the road.<sup>8</sup> In addition, loss severity could drive the special servicer’s pace on liquidation. Studies show that when potential losses are relatively small, the Special Servicer will liquidate loans in special servicing more quickly when holding the B-piece. When potential losses are large, the opposite is true as well.<sup>9</sup> Such variations in workout strategies present a burning question: who is to judge the prudence of the Special Servicer’s workout strategy if the Special Servicer only has to answer to itself or the junior debt holder? More importantly, can fiduciary responsibility to the Trust and interest to one specific security holder be reconciled?

In the study by Darling [2004], the author points out that the structural checks and balances that are supposed to protect the servicing standard are influenced by the Special Servicer’s expected overall profitability. The checks are the Trust’s ability to replace the servicers. The Trust can elect to replace the servicers when the servicers are found negligent. For

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<sup>6</sup> (Fitch Warns U.S. CMBS Special Servicers: Play Fair or Else, 2003)

<sup>7</sup> (Riddiough, 1997)

<sup>8</sup> (Darling, 2004)

<sup>9</sup> (Gan & Mayer, 2007)

a typical CMBS Trust, it requires a minimum two-thirds vote to amend minor issues and 100 percent approval on major issues.

Originally designed as liquidity support to the Trust, the Special Servicer's liability for matching payment can sometimes become a profit generator to the Special Servicer. Payment matching is intended to have the Special Servicer advance funds of their own to the security holders in the event of a timing mismatch for a payment due to special loan terms or a loan default. In some cases, the Special Servicer is required to advance funds to support property level operations such as environmental cleanup and capital improvements. Again in theory, the Special Servicer by virtue of its investment in the B-Piece, has an "equity position" in this matter and should put forth the best effort to recover the most for itself. But since the Special Servicer charges interest on the advances and when such advance is deemed non-recoverable based on inadequate property value, the servicer is entitled to reimbursement of the advance. The reimbursement would eventually come from proceeds payable to a more senior debt holder. With downside protection in the form of required reimbursement for advances, some Special Servicers could become aggressive or even reckless in advancing funds to the borrower without considering the value of the underlying asset.

"Fitch is concerned when a special servicer, based on its role in the transaction, creates self-serving revenue-garnering opportunities through excessive litigation, and/or opportunistic servicing by unnecessarily transferring assets into special servicing. The consequences occur when bondholders are not made whole on their investment due to the excessive costs associated with this type of servicing."<sup>10</sup>

Lastly, Darling calls the Special Servicer's compensation the ultimate balancing factor. In general, special servicer earns their fees from three main sources:

- A Special Servicing fee – a percentage per annum of the outstanding principal in the special service portfolio;

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<sup>10</sup> (Fitch Warns U.S. CMBS Special Servicers: Play Fair or Else, 2003)

- A Workout fee – a percentage of the outstanding principal and default interest; and
- A Liquidation fee – a percentage of the recovered payoff from the borrower or sale.

Both the Workout and Liquidation fees are senior to principal repayment and can reduce the principal payout to the senior debt holders. A Special Servicer could be tempted to resort to a strategy that would net themselves the most profit but not necessarily the maximum value to the Trust. Therefore, the priority of payment with regard to the Special Servicer's compensation is another conflict of interest between the different debt holders.

As mentioned in last section, the Special Servicer is entitled to the right to dispose of REO properties at par as a workout alternative. But often these properties have to be sold at discount due to market conditions, asset quality, and other reasons. The junior debt holder's special servicing role gives the junior debt holder an unparalleled edge – a look at the last high bid before it is required to submit its bid, if any. Consequently, bidders might bid less for foreclosed properties because they perceive that the asset is subject to an informal Right of First Refusal held by the Special Servicer. With such information, if the Special Servicer chooses to bid on the asset, the interest of the Trust could be compromised. This is clearly another agency risk that could have an impact on workout prudence.

Workouts strategies are controversial by nature since they often adversely affect one class of security holders while making another whole. Agency risk is always suspect in the eyes of the losing party. There may be no perfect workout, but is there a governance structure that can ensure workout prudence and rein in agency risk? The very constituent which gives value to CMBS - the rating agencies - obviously are aware of the structural deficiency. So is a structural overhaul due with respect to the issue of default resolution in CMBS? Can the current real estate firestorm be a catalyst to push for an upgrade to a CMBS 2.0?

## **Chapter Four - Case Background**

### **4.1 Brief History**

Peter Cooper Village—Stuyvesant Town, collectively dubbed "Stuy Town" by its residents, is a large private residential complex located on the East Side of Manhattan in New York City. The complex consists of two sister projects: Peter Cooper Village and Stuyvesant Town. The sister projects have a total of 56 red brick apartment buildings with typical housing project-style architecture. The development was a response to the housing demand from the returning veterans of WWII. Planned in 1943 and completed in 1947, the development site is approximately 80 acres, bounded by the East River/Avenue C on the east, the Gramercy neighborhood on the west, the East Village (or Alphabet City) to the south, and Kips Bay to the north. Stuyvesant Town, located between 14th and 20th Streets, has 8,757 apartment units in 35 residential buildings. Peter Cooper Village, located between 20th and 23rd Streets, has 2,493 apartment units in 21 buildings. The complex is currently housing about 25,000 residents. Named after the last Director-General of New Amsterdam, Peter Stuyvesant, whose farm occupied the site in the seventeenth-century, Stuy Town was one of the most successful icons for post WWII private housing development for middle-income citizens.

### **4.2 Change of Ownership**

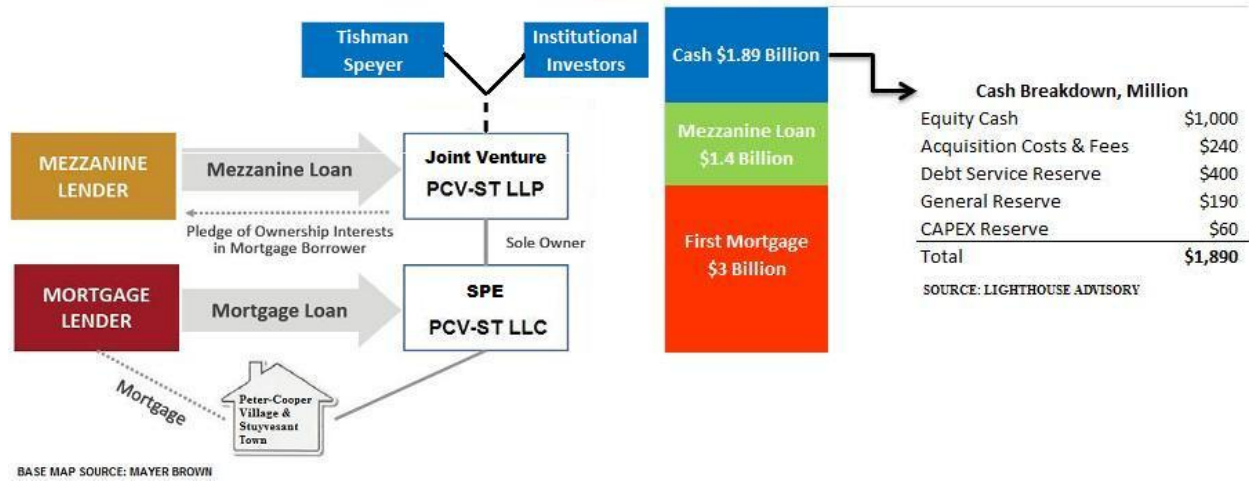
After almost 60 years of ownership, the complex developer and long time owner MetLife Insurance put the complex up for sale. The sale drew strong interest from potential buyers including New York's top real estate families, pension funds, and prominent foreign investors. A consortium of investors led by the joint venture of Tishman Speyer and Blackrock eventually won the bidding war and acquired the property for \$5.4 billion<sup>11</sup> in the fall of 2006. The

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<sup>11</sup> This purchase price did not include the \$890 million in fees and reserves. See Deal Structure & Capitalization.

transaction was the biggest single property sale in US real estate history. The figure below shows how the acquisition was structured and capitalized.

**Figure 9 Deal Structure and Capitalization**



### 4.3 Value Creation Strategy

Started in 1943, New York’s rent control program is the longest-running program in the United States. For more than sixty years, New York City has been a strong rent-control city. New York City landlords cannot increase rental rates on rent stabilized<sup>12</sup> units more than 4% a year. But the rent control rules have been loosened somewhat over the years. With strong economic growth and demand for housing units, developers were incentivized to convert apartments from controlled rent to market rent. Under the “luxury decontrol” provision of 1994, when (i) rents exceed \$2,000 on vacancy or (ii) an existing tenant’s income exceeds \$175,000 for two consecutive years and the rent for their apartment exceeds \$2,000, the owner could apply to

<sup>12</sup> New York State’s rent regulation programs consist of rent control and rent stabilization. Rent regulation is intended to protect tenants in privately-owned buildings from illegal rent increases and allow owners to maintain their buildings and realize a reasonable profit. Rent control is the older of the two systems of rent regulation. It dates back to the housing shortage immediately following World War II and generally applies to buildings constructed before 1947. Rent stabilization generally covers buildings built after 1947 and before 1974. Rent stabilization provides protections to tenants besides limitations on the amount of rent. Tenants are entitled to receive required services, to have their leases renewed, and may not be evicted except on grounds allowed by law. Leases may be renewed for a term of one or two years, at the tenant's choice. Rents may be reduced if services are not maintained.

Division of Housing and Community Renewal to remove that apartment from Rent Stabilization/Control. Better yet, a property tax incentive program called J-51 program, administered by the New York City Department of Housing Preservation and Development, grants partial property tax exemption and abatement benefits to owners to encourage the renovation of residential properties. By plowing \$150 million (\$12,000 per unit) into building renovations during the first three years, the Tishman-led partnership projected that they would be able to bring the complex to higher market rents and enjoy J-51 tax benefits simultaneously. At the time of the acquisition, 72 percent, or about 8,025 of the units, mostly one- and two-bedroom apartments, were rent-stabilized and the operating income from the rent rolls covered only 58% of the monthly debt service payments. Stabilized rents were on average less than half the cost of market rents. The debt service payment to the first mortgage alone was about \$16 million per month. It was expected that the debt service payment shortfall would diminish over the loan term as more and more units were “luxury decontrolled” and leased at market rates. Eventually, the complex’s net operating income (NOI) would triple to \$336 million in 2011 from \$112 million in 2006.

#### 4.4 First Mortgage

The \$3 billion first mortgage was secured against the property and was packaged into bonds through five CMBS<sup>13</sup> offerings as shown below:

**Figure 10 CMBS Backed by the First Mortgage**



<sup>13</sup> “Appaloosa Files Motion to Take Control of StuyTown”, February 25, 2010, Commercial Real Estate Direct.

The five CMBS offerings also contain other mortgages and the aggregate principal amount of the Certificates issued by these five CMBS Trusts is \$22.6 billion. The five Trusts share the proceeds from the Notes and Mortgage on Stuy Town on a pari passu basis. This \$3 billion first mortgage is a ten-year interest-only loan with a fixed rate of 6.434% and maturity date on 12/8/2016. Additional debt was to be permitted in the amount of up to \$300 million between November 8, 2011 and May 8, 2013. The additional debt may be in the form of pari passu mortgage debt or subordinate mezzanine financing. Wachovia Bank is the Master Servicer and CWC Capital Asset Management (“CWCAM”) is the Special Servicer.

#### **4.5 The Unexpected**

Less than a year after the acquisition, however, the real estate market tumbled. The costs associated with converting rent-controlled units into market-rent units turned out to be 11% higher than anticipated and the average rental income at the rent-controlled units was 10% lower than anticipated. Furthermore, in a tenant-initiated suit against Tishman Speyer Properties on March 5, 2009, judges from the Appellate Division of the New York Supreme Court ruled that owners of properties receiving a J-51 tax abatement<sup>14</sup> cannot deregulate rent regulated apartments and Tishman Speyer had illegally displaced thousands of rent-regulated tenants from their homes. The decision was appealed, but on October 22, 2009, the ruling was upheld by the Court of Appeals<sup>15</sup>. Both MetLife and the Tishman-led partnership were found liable for a total of \$215 million in rent rebates to the affected tenants. The court ruling effectively put all the apartment units in Stuy Town under rent control at least until 2017.

At this time, changes are being proposed to the “luxury decontrol” thresholds. These potential

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<sup>14</sup> “Ironically, since the complex joined the J-51 program in early 1990s, the cumulative J-51 tax benefit received has only been \$27.4 million while the property taxes levied have been \$532.8 million.”, CMBS Research, Deutsche Bank, November 30, 2009.

<sup>15</sup> The New York Court of Appeals is the highest court in New York. Unlike those in most other U.S. states, New York’s Supreme Court is a trial and intermediate appellate court, not the court of last resort.

changes include an increase of the rent threshold to \$2,700 and the income threshold to \$250,000. According to an analysis by Fitch Ratings, this can extend a unit's participation in the rent regulation program up to eight additional years.

Unable to charge pro-forma rents, the complex had a NOI of only \$125 million for 2009. In early November of 2009, there was only \$6.8 million left in the interest reserve and the Loan was transferred to special servicing due to an imminent default. On January 8, 2010, the partnership defaulted on the \$3 billion senior mortgage and the \$1.4 billion mezzanine debt. On January 29, 2010, the Trusts notified the partnership that the unpaid debt outstanding was accelerated, immediately due and payable. Finally, on February 18, 2010, CWCAM<sup>16</sup> filed to seek foreclosure on the property. Prior to this notice, the partnership had indicated that they would surrender the ownership to creditors, thereby avoiding a bankruptcy of the complex. Given the size of its debt, the default of Stuy Town helped drive the U.S. CMBS delinquencies 85 basis points (“bps”) higher to 7.14% in March, according to the latest index results from Fitch Ratings. Stuy Town alone contributed 61 bps of the 85 bps.

Subsequent to CWCAM’s foreclosure filing, Appaloosa Investment, a New Jersey-based hedge fund that had purchased Certificates with a face amount of \$750 million within the \$22.6 billion pool at a steep discount after the Loan was transferred to special servicing, filed a motion to intervene CWCAM’s foreclosure. In its motion, Appaloosa stated that CWCAM violated its obligations as Special Servicer to act as a prudent commercial mortgage servicer seeking to maximize value for the benefit of all Certificateholders. Representing approximately 3.3% of the principal balance of the Certificates, Appaloosa argued that a foreclosure would incur a double

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<sup>16</sup> CWCAM = CW Capital Asset Management, the Special Servicer of the five CMBS transactions.

taxation from ownership transfers<sup>17</sup> and the possibility of inheriting the J-51 rent rebate liability from the borrower. And these two charges would consequently create unnecessary losses to the bondholders in the CMBS Trusts. According to Appaloosa, the two charges could be avoided if CWCAM pushed the borrower into bankruptcy.

Lastly, CWCAM's refusal to have any dialogue regarding the foreclosure and its affiliation with the Directing Class had created a situation in which no other party could adequately represent Appaloosa's interests and hold CWCAM accountable to perform its obligations as Special Servicer to act in the best interests of all of the Certificateholders. The claims made by Appaloosa in this case seem to be lending real life testimony to the results from literature reviews in previous chapter. Although the findings of this case are not necessarily representative of the industry, they do offer real life reinforcement of the seriousness of the structural issues that have been long discussed in both academic and professional arenas. To determine the workout prudence in the Stuy Town case, this study examines: (i) loss severity to the Trusts and (ii) compensation for the Special Servicer. The loss severity compares the financial impacts under the two debated fallout scenarios: liquidation and bankruptcy, while compensation looks at the probable fees collected by the Special Servicer under the two scenarios.

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<sup>17</sup> The combined New York State and city transfer taxes, levied whenever a property changes hands, are 3.025 percent. In a traditional building sale, the tax is a percentage of the purchase price and is paid by the seller. For distressed properties, the tax responsibility usually lies with the lender if the borrower can't pay. In the case of Stuy Town, transfer tax will be levied against the property once when the title is transferred by foreclosure and once again from the subsequent sale. In a foreclosure, the tax is based on the higher of either the fair market value or the value of the mortgage.

## Chapter Five – Lender’s Options

To determine the most prudent workout strategy for a non-performing loan<sup>18</sup>, lenders typically look to two critical parameters:

- (1) The real estate space market conditions (market-level rental rates and vacancy rates);
- (2) The equity position in the mortgage.<sup>19</sup>

These two parameters often dictate the timing, pricing and form of an asset sale. Facing a non performing loan, lenders usually have the following alternatives:<sup>20</sup>

### 1. Note Sales and Note Participation Sales

Lenders can sell the note to an unaffiliated third party or reduce their risk of loss from the loan by selling a "subordinate" interest(s) in the note to other lenders. For example, the mortgage can be bifurcated into component notes: an A note, a B note, and a C note component. Although considered to be in a senior position, the A note typically receives its proportionate share of interest and principal pari passu with the B and C notes as long as the whole loan is performing. However, upon an event of default, the A note component becomes senior to the B and C note components and receives all cash flow until it is fully repaid.

### 2. Pre-packaged Note Sale with Deed in Lieu of Foreclosure

Lenders can sell the note and deed of Trust to a purchaser as the borrower concurrently executes a deed in lieu of foreclosure conveying title to the property to a subsidiary of the note purchaser. In this transaction, the note buyer acquires the lender's rights under the note secured by the deed of Trust while a subsidiary of the note buyer acquires the underlying real estate. Under this structure, the estates are not merged, preserving the note purchaser's ability to later foreclose on the real property.

### 3. Workouts with Borrower

Lenders can choose to leave the borrower in control of the assets. In exchange, the lenders will attain an enhanced position in the debt in the event of an unsuccessful workout or a subsequent borrower bankruptcy. Lender would enter into a forbearance agreement not to exercise its default remedies as long as the borrower adheres to the new terms in the forbearance agreement. The most common solution is interest rate reduction and/or principal write-down. Lenders would typically attain more favorable loan terms such as control over cash flow, additional security or guaranties and additional representations from the borrower.

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<sup>18</sup> International Monetary Fund: non-performing loans consist of a) other real estate owned which is that taken by foreclosure or a deed in lieu of foreclosure, b) loans that are 90 days or more past due and still accruing interest, and c) loans which have been placed on nonaccrual (i.e., loans for which interest is no longer accrued and posted to the income statement).

<sup>19</sup> (Chen & Deng, 2003)

<sup>20</sup> (Jeffer Mangels Butler & Marmaro)

#### 4. Consensual Deed in Lieu of Foreclosure with Borrower

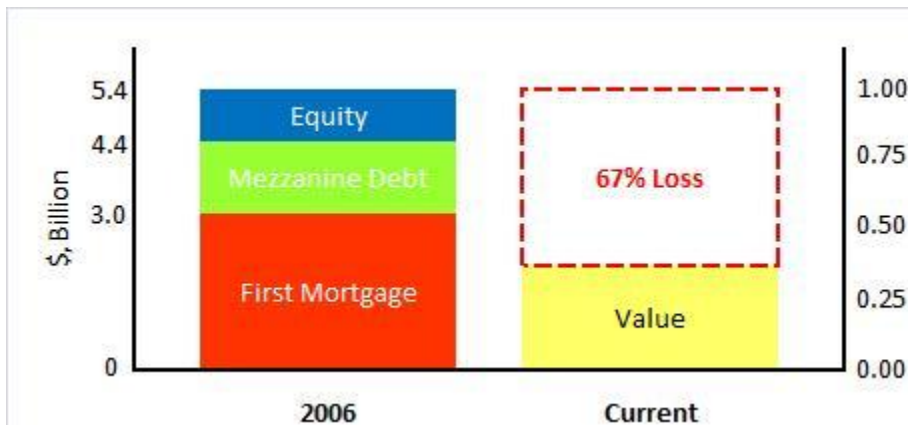
This workout strategy is more expedient and less expensive compared to foreclosure. If the property is free of subordinate liens and the borrower is ready to "hand over the keys", this strategy avoids the time delay associated with navigating through the foreclosure process and potential bankruptcy issues such as a court approved "cramdown" or delays in obtaining relief from the automatic stay to proceed with foreclosure.

#### 5. Foreclosure

Once a lender determines not to restructure the loan and if a deed in lieu of foreclosure is not feasible, a primary remedy is foreclosure of the assets securing the loan. While the foreclosure action can be an effective strategic move to secure the collateral, it may also drive a borrower to file a bankruptcy petition to stay the foreclosure process. Delay and litigation costs associated with the bankruptcy can be quite significant.

With Stuy Town currently valued at less than \$2 billion and an outstanding first mortgage of \$3 billion, both the equity and mezzanine position are clearly "under water". Tishman Speyer's decision to "hand over the keys" to the Special Servicer has enabled the partnership to cap its losses at the equity invested (\$1.89 billion) and permanently free itself from the debt liability. The following figure shows how the loss of property value affected the ownership positions.

**Figure 11 Change in Property Value**



Some may argue that Tishman Speyer should have sought bankruptcy protection so that they could have had a chance to benefit from a "cramdown" or force the lender to restructure the loan on more favorable terms. To support this argument, one must first examine the deal structure and the upside potential for continuous ownership control. Within the \$1.89 billion

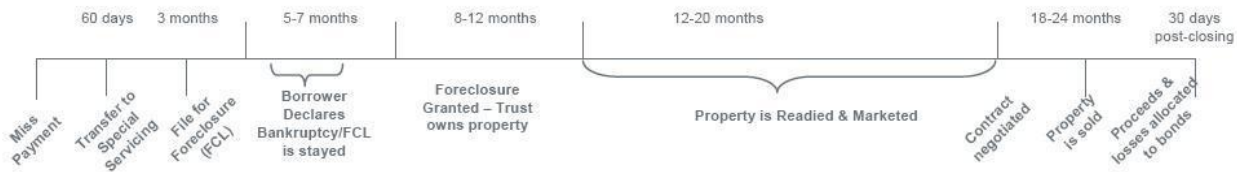
sponsor equity, Tishman Speyer's equity contribution was only \$112 million. Given the scale of the acquisition, it is fair to say that Tishman Speyer itself walked off largely unscathed while the partnership lost close \$1.9 billion. In addition to the \$3 billion first mortgage secured by the property, the partnership had also pledged its equity interest as collateral for a \$1.4 billion mezzanine loan at the time of acquisition. As a result, foreclosure by the first mortgage would wipe out all of the existing equity and mezzanine debt positions on the property. Any debt restructuring would likely have required an "equity kicker" from the partnership and created enhanced claim positions for the lenders in return. It should be noted that the J-51 rent rebate would survive either bankruptcy or foreclosure and cannot be reduced due to the tenants' right of recoupment. This rebate liability would have to be shouldered by the eventual owner of Stuy Town. The pending \$215 million rent rebate, the owner's inability to raise rent until 2017 (the earliest), and the uncertainty in market recovery made the ownership of the complex very unappealing to both the partnership and the mezzanine debt lenders, who could have stepped in and taken over the ownership of existing equity position. With no up-side potential in sight, Tishman Speyer and its institutional equity partners (who had already written down their initial investment) were better off to simply "abandon ship".

Lastly, bankrupting the property in an attempt to retain control would further dent the reputation of Tishman Speyer and prolong the legal entanglement. Therefore, relinquishing ownership to the lender voluntarily was a necessary and prudent tactical move for the Tishman-partnership. For the lender, it must be remembered that the Tishman-partnership is only a Special Purpose Entity (SPE) and this SPE does not have any assets other than the 56 apartment buildings. Therefore, both voluntary and involuntary bankruptcy would incur significant incremental losses to the lenders and require a maturity extension. According to the major

Special Servicers<sup>21</sup> and legal professionals<sup>22</sup> who are specialized in loan workouts, forcing the borrower into bankruptcy is not a prudent strategy since the proceeding takes away lenders' control of the loan terms, incurs significant legal costs, and delays asset realization.

As unpredictable as it is, the foreclosure process usually takes 12 to 18 months.<sup>23</sup> The Tishman-partnership's deed-in-lieu-of-foreclosure would certainly help speed up the process for the Special Servicer and reduce the litigation costs. It was arguably the best among bad alternatives, both for the borrower and the lender. The follow sketch depicts the most common progression in a foreclosure action.

**Figure 12 Foreclosure & Sale Timeline<sup>24</sup>**



<sup>21</sup> CWCaptial, and Midland.

<sup>22</sup> Keith Barnett and Douglas Burton of Wilmer Hale.

<sup>23</sup> (Riddiough, 1997)

<sup>24</sup> MBIA

## Chapter Six - Loss Severity Comparison

### 6.1 Foreclosure & Liquidation

If Stuy Town were foreclosed and liquidated at its current value of \$1.8 billion, the first mortgage would realize a loss of \$1.6 billion.<sup>25</sup> To understand what this figure means in terms of loss severity to the bondholders, one must first look at the tranche structure of the CMBS that financed the senior mortgage. The following figure shows the tranche structure of the Wachovia Bank Commercial Mortgage Trust (WBCMT), 2007-C30<sup>26</sup>.

**Figure 13 WBCMT 2007-C30 Tranche Structure<sup>27</sup>**

Class	Rating	Credit Support (%)	Pool Summary
A-1	Aaa	30.000	Balance \$7,903,498,737
A-2	Aaa	30.000	Collateral 263 fixed rate loans
A-3	Aaa	30.000	328 commercial and multifamily properties
A-4	Aaa	30.000	Structure Sequential Pay with Super-Senior Aaa Classes
A-PB	Aaa	30.000	
A-5	Aaa	30.000	1 Mezzanine AAA Class.
A-1A	Aaa	30.000	2 Subordinate Aaa Class.
A-M <sup>1</sup>	Aaa	20.000	3 Interest-Only Class; distribution are made without regard to Loan Group.
A-J <sup>2</sup>	Aaa	11.500	NR = Not Rated
B	Aa1	10.875	Source: Moody's Investors Service
C	Aa2	9.875	
D	Aa3	9.000	
E	A1	8.250	
F	A2	7.375	
G	A3	6.125	
H	Baa1	5.125	
J	Baa2	4.000	
K	Baa3	3.000	
L	Ba1	2.500	
M	Ba2	2.250	
N	Ba3	1.875	
O	B1	1.625	
P	B2	1.500	
Q	B3	1.250	
S	NR	0.000	
X-P <sup>3</sup>	Aaa	N/A	
X-C <sup>3</sup>	Aaa	N/A	
X-W <sup>3</sup>	Aaa	N/A	

<sup>25</sup> CMBS Research, Deutsche Bank, November 30, 2009: the valuation is based on the 2009 in-place NOI of \$125 million and a 7% cap rate. The loss figure includes loss of principal and interest, transfer taxes, legal fees and expenses (5%) related to selling the property. However, the loss figure does not include the \$215 million judgment or any other future legal judgments.

<sup>26</sup> Each of the five CMBS offerings has a different tranche structure along with different credit support. For the purpose of simplicity and demonstration, this study looks at (WBCMT), 2007-C30 only. Same principles apply to the other four.

<sup>27</sup> Wachovia Bank Commercial Mortgage Trust, Commercial Mortgage Pass-Through Certificates, Series 2007-C30. Pre-sale report, Moody's Investors Service, March 8, 2007.

The five CMBS offerings share proceeds as well as losses on pari passu basis. Using WBCMT 2007-30 as an example, this deal securitized \$1.5 billion of the \$3 billion first mortgage and would therefore shoulder 50% or \$807 million of the \$1.614 billion loss. The loss of \$807 million amounts to 10.2% of the WBCMT 2007-C30 Trust's \$ 7,903,498,737 outstanding principal balance. This 10.2% loss would wipe out bond classes from NR all the way up to C, which has a 9.875% credit support. In response to the market conditions and the fallout from the J-51 litigation, rating agencies anticipated credit losses and downgraded the credit rating on the affected bond classes. In this example, rated Aa2 at origination by Moody's, Class C was downgraded to Baa1 months before the Stuy Town default. The same principles were applied to the calculations of the losses associated with the other four CMBS. The following table shows the loss severity and the current rating for the other four CMBS Trusts, respectively. The deviations in credit rating among the five CMBS are due to the different tranche structure associated with each CMBS.

**Figure 14 Loss Severities if Foreclosed<sup>28,29</sup>**

Deal Name	Realized Loss (\$mm)	Realized Loss (%)	Highest Class Impacted	Original Rating (M/S/F)	Current Rating (M/S/F)
WBCMT 2007-C30	\$ 807.1	10.20%	C	Aa2/AA/AA	Baa1/B-/BB
ML-CFC 2007-5	\$ 430.4	9.90%	B	Aa2/AA/AA	Baa1/B-/BB
COBALT 2007-C2	\$ 134.5	5.60%	H	Baa1/-/BBB+	B1/-/B-
WBCMT 2007-C31	\$ 133.3	1.90%	N	Ba3/BB-/	Ca/CCC-/
ML-CFC 2007-6	\$ 108.8	5.10%	G	Baa2/-/BBB	B3/-/B-
<b>Total</b>	<b>\$1,614.1</b>	<b>7.10%</b>			

(M/S/F) = Moody's/Standard & Poor's/Fitch

<sup>28</sup> CMBS Research, Deutsche Bank, November 30, 2009.

<sup>29</sup> At securitization, COBALT 2007-C2 AND ML-CFC 2007-6 were not rated by Standard & Poor's while WBCMT 2007-C31 was not rated by Fitch.

## 6.2 Bankruptcy<sup>30</sup>

Based on the NOI of 2009, the partnership would have to bridge an annual interest payment short fall of about \$70 million in order to keep the first mortgage current. Assuming the current loan terms forward and expiration of rent control in 2017, the NOI would breakeven with the debt service payment (DSCR of 1.0x) in about 2036<sup>31</sup>. To retain their ownership of Stuy Town to this point, the partnership would have to inject at least \$600 million of fresh equity. If the partnership were to file for bankruptcy protection, the most probable and meaningful outcome would be a loan restructuring. Such restructuring typically consists of an interest rate reduction and/or a partial principal balance write-down. In order for the property to be able to keep the loan current at a DSCR of 1.1, it was projected that the interest rate would have to be cut from the current 6.43% to 3.7%.<sup>32</sup> The following figures show the loss severity associated with interest rate reduction and principal write-down, respectively.

**Figure 15 Loss Severity if Interest Rate Reduced<sup>33</sup>**

Deal Name	Interest Shortfall (\$mm)	Highest Class Impacted	Original Rating (M/S/F)	Current Rating (M/S/F)
WBCMT 2007-C30	\$ 3.7	C	Aa2/AA/AA	Baa1/B-/BB
ML-CFC 2007-5	\$ 2.0	B	Aa2/AA/AA	Baa1/B-/BB
COBALT 2007-C2	\$ 0.6	G	A3-/A-	Ba2-/B-
WBCMT 2007-C31	\$ 0.6	K	Baa3/BBB-/-	Caa1/CCC+/-
ML-CFC 2007-6	\$ 0.5	F	Baa1-/BBB+	B1-/B-

<sup>30</sup> CMBS Research, Deutsche Bank, November 30, 2009.

<sup>31</sup> CMBS Research, Deutsche Bank, November 30, 2009: it was assumed that current rents could only grow 4% annually under the Rent Control regulations from now through 2017. Once exits the Rent Control program in 2017, rents would then be doubled to reflect the market rates and the annual rent increase would be 3.5% going forward.

<sup>32</sup> Deutsche Bank: 2009 net cash flow estimate of \$125 million and a required DSC of 1.1. Alternatively, with interest rate kept at 6.43%, the Trusts would have to write down \$1.28 billion or 43% of the outstanding principal balance.

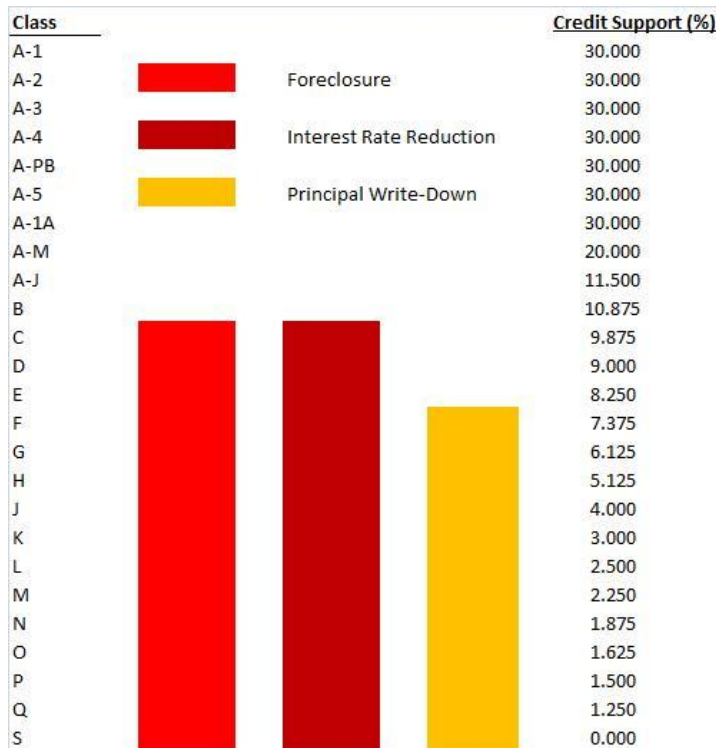
<sup>33</sup> CMBS Research, Deutsche Bank, November 30, 2009.

**Figure 16 Loss Severity if Principal Written Down**

Deal Name	Realized Loss (%)	Highest Class Impacted	Original Rating (M/S/F)	Current Rating (M/S/F)
WBCMT 2007-C30	7.80%	F	A2/A/A	Ba1/CCC-/B-
ML-CFC 2007-5	7.50%	D	A2/A/A	Ba1/A-/BB
COBALT 2007-C2	4.30%	J	Baa2-/BBB	B2-/B-
WBCMT 2007-C31	1.80%	P	B2/-	Ca/-
ML-CFC 2007-6	3.90%	H	Baa3-/BBB+	Caa1-/B-
<b>Total</b>	<b>5.50%</b>			

Pursuant to the Servicing Standard, the workout strategy that would net the maximum recovery on net present basis prevails. The following figure is a graphical comparison of the loss and impact on bond classes associated with the strategies described above.

**Figure 17 Loss Severity and Impact Comparison**



As shown on the figures, foreclosure and interest reduction would incur greater losses and affect more senior bondholders. Therefore, restructuring the first mortgage by a principal write-down appears to be the most prudent workout strategy with respect to the Servicing Standard. It must be noted that the Special Servicer has the power to restructure the existing mortgage without putting the asset and the borrower through the bankruptcy proceeding.

## Chapter Seven - Fee Comparison

### 7.1 Compensation Structure

The PSA of WBCMT 2007-C30<sup>34</sup> set the compensation for the Special Servicer as follows:

- A Liquidation Fee: the lesser of
  - (i) 0.50% of any whole or partial cash payments of liquidation proceeds received,
  - (ii) \$15,000,000.
  
- A Workout Fee: the lesser of
  - (i) 0.50% of all payments of interest and principal received on such mortgage loan for so long as it remains a corrected mortgage loan,
  - (ii) \$15,000,000.
  
- A Special Servicing Fee - on the basis of a 360-day year consisting of twelve 30-day months, accrues at a rate (the “Special Servicing Fee Rate”) equal to 0.25% per annum, and is computed on the basis of the same principal amount and any related interest payment due on such Specially Serviced Mortgage Loan or REO Mortgage Loan. The Special Servicing Fee with respect to any Specially Serviced Mortgage Loan (or REO Mortgage Loan) will cease to accrue if such loan (or the related REO Property) is liquidated or if such loan becomes a Corrected Mortgage Loan.

Since these fees have a “super-senior” claim priority, the Special Servicer will get paid before the “Super Duper Senior” receives its interest payment and/or principal repayment.

### 7.2 Liquidation Fee

As mentioned earlier, the first mortgage would realize a loss of \$1.6 billion if Stuy Town were foreclosed and sold at \$1.8 billion. As a result, the proceeds from liquidation would be approximately \$1.4 billion<sup>35</sup> and the Special Servicer would earn a liquidation fee of \$7 million.

### 7.3 Workout Fee

This study calculates the workout fee based on a principal write-down since it was the most prudent strategy as demonstrated in previous section. To keep the first mortgage current at the

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<sup>34</sup> According to the Co-Lender Agreement, the governing PSA for purposes of CWCAM’s administration and servicing of the Loan is the PSA for the 2007-C30 Trust.

<sup>35</sup> Net proceeds after transfer taxes, legal fees and sales expenses, CMBS Research, Deutsche Bank, November, 30, 2009.

existing 6.43% interest rate<sup>36</sup>, the outstanding principal balance would have to be reduced to \$1.72 billion. As a result, the modified annual debt service payment would be approximately \$110 million and the workout fee would be \$550,000 annually. Assuming no recurrence of default, the maximum amount of workout fee the Special Servicer could collect would be \$3.85 million over the next 7 years.<sup>37</sup>

#### **7.4 Special Servicing Fee**

Assuming a 12-month period for both the foreclosure and workout process, the Special Servicer would be entitled to a fee of \$7.5 million based on the outstanding principle balance of \$3 billion. If Stuy Town becomes REO, the Special Servicer would likely to receive \$4.5 million<sup>38</sup> annually for servicing the loan.

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<sup>36</sup> This study assumes that the loan stay as an Interest Only loan with the original maturity date of 12/8/2016.

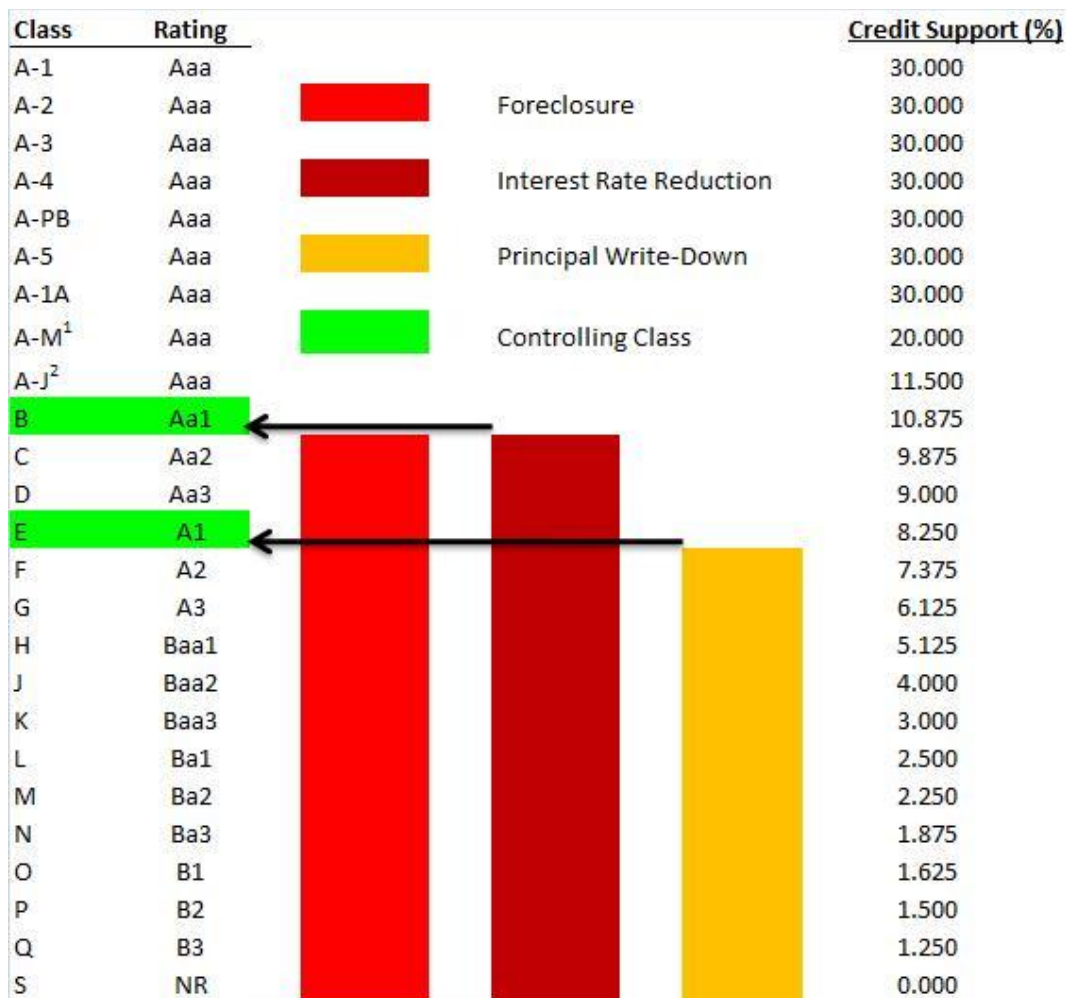
<sup>37</sup> The remaining years on the loan, 2010 to 2016.

<sup>38</sup> Assuming market value of \$1.8 billion as the new outstanding principal balance.

## Chapter Eight - Controlling Classholder Rights

As the real estate market continues to trend downward, the CMBS Trusts are accumulating losses. As a result, the subordinate bond classes are being wiped out and the position of the Directing Certificateholder is being pushed up progressively. Once the principal balance of their bond classes is reduced to zero, the B-Piece buyer or the bondholder of the most junior tranche will no longer have the rights to influence the servicing of the loan and the opportunities to earn fees. If the loss of control is imminent, it becomes tempting for the Controlling Certificateholder to defer losses so that its tranche can be “in the money” for as long as possible.

**Figure 18 Shift in Controlling Class Position With Respect to Loss Severity**



Given that the B-Piece buyer's investment positions are between Class H and Class S, any of the three workout strategies would wipe out its positions and shift the Directing Certificate or consent rights upward to the investment grade bondholders as shown in the graph above. So what difference would the Special Servicer's strategies make if the outcomes are the same?

To answer this question, we must first understand how the Trust realizes a loss. According to the PSA, the aggregate principal balance changes after the final disposition of a mortgage loan and allocation of proceeds based on the waterfall structure. The act of foreclosing on a property securing a mortgage loan does not change the principal balance of any of the certificate classes. After the ultimate disposition of a foreclosed property, the Special Servicer determines the recovery with respect to the property and calculates the Realized Loss. This Realized Loss will then be used to determine the Directing Class going forward. Since the Special Servicer has latitude in pricing the foreclosed property, it can certainly overprice the property to "turn away" potential buyers. If the liquidation is unsuccessful, the foreclosed property will become REO. Under REMIC provisions, the Special Servicer can hold REO assets for at least three years. Such approach will allow the B-Piece buyer to delay the change of control, collect Special Servicing Fees and continue to enjoy the informal First Right of Refusal on defaulted loans. With a loan restructuring, modification of the interest rate and/or principal will incur an almost "instant" realization of loss and shift the Controlling Certificate upward. Therefore, a foreclosure that results in an REO property can be a "game changer" if the Special Servicer wants to retain control of the defaulted loans.

## **Chapter Nine - Conclusion**

### **9.1 Case Finding**

Based on the analysis of loss severity and the Special Servicer's vested interests with respect to the different workout strategies, it appears that foreclosure, which is the current course of action undertaken by the Special Servicer, was not the most prudent resolution to Stuy Town with respect to the Servicing Standard. Historically, the foreclosure and sale of REO has yielded the lowest net recoveries as a resolution alternative for defaulted commercial real estate debt.<sup>39</sup> In the current depressed market, the liquidation price will be mainly driven by bargain hunters who are looking for a steep purchase price discount and, who want to take advantage of a lender's eagerness to unload non-performing assets. The pending J-51 rent rebate and the owner's uncertain ability to raise rents will require potential buyers to factor in a thick downside protection cushion. Lastly, financing a deal of this size in today's dislocated capital market will certainly be a challenge. All these factors will combine to produce low bids and disposing the complex under these conditions is tantamount to a fire-sale. Therefore, restructuring the loan and allowing the current owner to continue to manage the complex would have yielded a better value to the Trust.

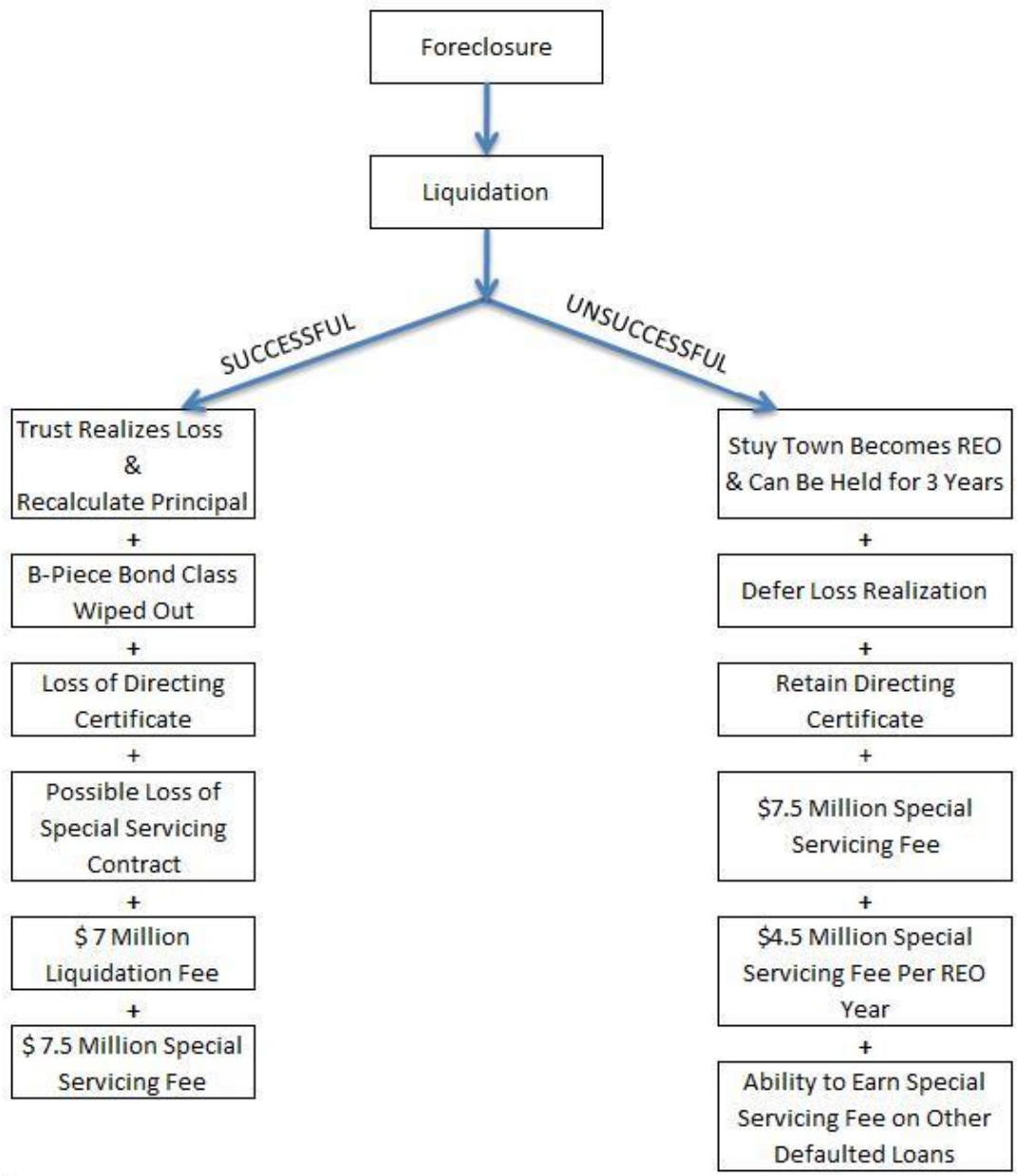
Pursuant to the Servicing Standard, the Special Servicer is obligated to employ the same skill, care and diligence as in managing its own assets, and to act without regard to any proprietary interests, relationships with borrowers, or its compensation. This study finds that conflict of interest may have affected the Special Servicer's workout prudence. The B-Piece buyer's ability to enhance its ex-post return by prolonging its Directing Certificateholder position to earn more fees and to retain control of defaulted loans is in direct conflict with the justified and compliant strategy. The overlapping role of investor and servicer provided the investor with

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<sup>39</sup> (Berger, 2010)

the incentive and platform to deviate from the PSA. Agency risk appears to have played out in this case. This study projects the foreclosure strategy can play out in one of the two possible ways as shown in the following diagram:

**Figure 19 Post-Foreclosure Development**



By foreclosing on the property, the Special Servicer obtains the ability to determine the post-foreclosure outcomes. Given the loss severity incurred by Stuy Town, liquidation even at the current market price of \$1.8 billion will trigger a shift of the Directing Certificate in WBCMT 2007-C30. Since the Special Servicer controls the pricing of the defaulted loans, it has the ability to chill the interests of potential buyers with a high minimum bid. If the liquidation is not successful, Stuy Town will become an REO property. There will be no change in the Directing Class since the loan is still on the Trust's books and no loss will be realized. The Special Servicer can continue to earn an annual servicing fee on the defaulted loans. In addition, such control gives the B-Piece a chance to wait for the market to turn around. By holding onto the Controlling Certificate, the B-Piece buyer will have the opportunity to recoup part of its initially lost investment, and to buy out defaulted loans on the cheap by exercising the informal First Right of Refusal – a look at the last high bid. The Special Servicer has compelling incentives to choose a workout strategy that is not compliant with the Servicing Standard.

“As realized losses occur they reduce the interest paid and erode the principal balance of the subordinate classes. As the potential loss of control looms, the value of the special servicing revenue stream may be significantly greater than the subordinate bonds themselves. Fees may be earned by the Special Servicer potentially on all assets in the Trust, which could dwarf the future interest payment stream on the subordinate bonds. Deferring realized losses delays the loss of control and allows the revenue stream from special servicing management fees to continue for the benefit of an affiliated Directing Certificateholder.”<sup>40</sup>

Based on the analysis results presented above, this study has the following conclusion:

- With respect to the governing PSA and the NPV analysis, a bankruptcy or a loan modification appears to be the prudent workout strategy to resolve the Peter Cooper Village – Stuyvesant Town mortgage loan default;

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<sup>40</sup> (Berger, 2010)

- Although forcing the borrower into bankruptcy may appear to be a more complex and uncertain resolution, the Special Servicer is obligated to see to the bankruptcy proceeding because it is demonstrated to achieve maximum recovery on a NPV basis in this case. Alternatively, the Special Servicer could have worked with the borrower and modified the loan without going through the bankruptcy process. From the PSA standpoint, a loan modification/restructuring appears to prevail over a foreclosure.
- The B-Piece buyer's vested interests in the outcome may have clouded its special servicing arm's judgment during the workout process.

This case study has shown that the governing structure of the CMBS may fail to rein in the well-known agency risk and, therefore, may be prone to self-interested parties' abuses. In a typical CMBS structure, senior investors provide over 70% of the capital<sup>41</sup>, but have no influence over Special Servicers' asset resolution strategies. From the senior bondholders' perspective, their economic interests are underrepresented while the B-Piece holders are given a disproportionate share of authority.

It must be emphasized that while the Special Servicer is obligated to serve the best interests of the Trust, the B-Piece holder or the Directing Certificateholder does not have a standard of care for the other bondholders, and can simply look to maximize its own best economic interests. It is true that the Special Servicer has the obligation to veto the Directing Certificateholder's direction if such direction violates the Servicing Standard<sup>42</sup>, but the Directing Certificateholder holds the ultimate "trump card" - replacing the Special Servicer without cause.

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<sup>41</sup> In legacy CMBS, senior capital accounts for over 90% of the total capital.

<sup>42</sup> The PSA generally will require the Special Servicer to disregard any direction from the Directing Class, even with respect to an action requiring the Directing Class's consent, if acting on such direction would violate the Servicing Standard. This is called "servicing standard override."

In the past twelve months, the B-Piece buyer arena has experienced a drastic change in ownership. As the “first loss” cushion, many major B-Piece buyers have seen most of their investments wiped out. Some have looked to exit while others are teetering on the brink of bankruptcy. Interestingly, their residual positions and their special servicing arm’s informal First Right of Refusal to buy the troubled assets from the Trust is a coveted gem to well-capitalized distressed investors. The following is a summary of the current status of the major players in the B-Piece arena:

1. LNR – in danger of bankruptcy. Current owner Cerberus is in talk with Vornado on recapitalization;
2. CWCcapital - previous owner Canadian pension fund manager Caisse de depot et placement du Quebec decided to exit and sold the position to Private Equity firm Fortress Investment;
3. Capmark Financial – bankrupt in 2009 and agreed to sell its servicing unit to Warren Buffett’s Berkshire Hathaway Inc. and Leucadia National Corp;
4. Centerline Holding – was on the brink of bankruptcy. It was eventually acquired by Andrew Farkas.

If the objective of these new owners is merely to scoop up assets on the cheap, their workout prudence will certainly be suspect and the “tranche war” among CMBS bondholders could further escalate. Why can’t the Special Servicers just play fair?

## 9.2 CMBS 2.0

Interviewing major CMBS participants<sup>43</sup> has confirmed a general consensus that the special servicing structure is fundamentally sound, but needs to confront three major challenges:

1. Conflict of interests
2. Lack of transparency
3. Unchecked latitude/discretion.

Evidently, these challenges not only affect workout prudence but also increase the likelihood of legal in-fights within the Trust. Well known to the industry for more than a decade, agency risk in the servicing mechanism has become most obvious when the B-Piece is suffering an unmanageable loss inflicted by the current downturn. It is now clear that fiduciary responsibility to the Trust and interest to one specific stake holder cannot always be reconciled. An upgrade to the servicing structure is needed.

Based on the findings of the case study and a detailed review of the PSA, this study has identified four operational parameters in the servicing structure that are most critical to overcoming the challenges mentioned above:

- Control of assets;
- Control of the trigger mechanism;
- The discount rate used in net present value calculation;
- Reporting of specially serviced assets.

### **Control of assets<sup>44</sup>**

In previous chapter, this study demonstrated how a subordinate investor can increase its ex-post return with its own special servicing arm. It is also not uncommon that subordinate bondholders

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<sup>43</sup> Interviews with Deutsche Bank, Midland Loan Services, CWCcapital.

<sup>44</sup> (Berger S. M., 2010)

that are not affiliated with Special Servicers view special servicing fees as a secondary means to enhance the return on their investments. For example, some Directing Certificateholders would negotiate with the non-affiliated Special Servicers for discounted fees from those specified in the PSA. Some would create revenue sharing in exchange for termination right waiver with the Special Servicer. These certainly are not the intended value and function of the approval right. Some industry practitioners have proposed to eliminate the Directing Certificateholder's asset plan approval rights or to prohibit the Special Servicer from being affiliated with the Directing Certificateholder. While the proposal appears to be a direct and effective means to eliminate the potential for conflict of interests, it has not been well received by the existing B-Piece investors with special servicing arms. Such a proposal has the potential of depressing the level of interest in future CMBS from the B-Piece buyers and alternative high-yield investors if they cannot participate as the Directing Certificateholder. To B-Piece investors, the approval right involves pricing as well as interest representation. B-Piece investors fear that if senior investors are granted too much control, their self-interest may steer resolution strategy predominantly towards quick and even deeply discounted liquidations. As a result, the senior investors will receive accelerated principal repayment. Therefore, any proposed changes in the Directing Certificate assignment will have to be a delicate balancing act and the discussion is still ongoing between the different constituents in the industry. Absent an acceptable fix to all parties at this time, B-Piece buyers will continue to be able to participate as the Directing Certificateholders since CMBS issuers probably do not want to take the risk associated with structuring transactions that will alienate the existing B-Piece investors. A recent CMBS forum<sup>45</sup> has also discussed the possibility of changing the Special Servicer's loan purchase option. Currently, the Special Servicer has active control over the pricing of defaulted loans and such informal Right of First

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<sup>45</sup> The CMBS Investment Grade Bondholder Forum on June 11, 2010.

Refusal has the potential to run counter to the objective of maximum recovery. In the future, the Special Servicer may only purchase a defaulted loan or REO out of the Trust through competitive bidding supervised by the Trustee. This competitive bid requirement can disincentivize Special Servicers to use liquidation as a “back-door” acquisition of defaulted assets and can enhance the competition among the bidders.

Lastly, and also most importantly, senior bondholders are contemplating the installation of an Operating Advisor whose responsibilities will include:

- Advisory rights with respect to special servicing resolution plans;
- Preparation of reports to all certificate holders on special servicing outcomes, to be disclosed after special servicing decisions have been executed;
- Scheduling and organizing bondholder votes when required (i.e. replacing special servicer or other party, etc.);
- Obtaining and maintaining the same information that gets provided to rating agencies on an on-going basis;
- Acting as a liaison between investors and Trustee/servicers with respect to data integrity issues to ensure all data fields are correct and complete;
- Actively monitor servicer reporting practices, which may include substantive and compliance testing of reporting and servicing functions on a periodic basis; and
- Advising the Trustee to withhold compensation to servicers or other parties for failure to produce the contractually agreed information.

### **Control of the trigger mechanism**

Currently, loss realization is calculated only after the ultimate disposition of the foreclosed property. This creates an incentive for Special Servicers to defer losses in order to retain the Directing Certificateholder status. Such practice is a structural concern for potential conflict of interest and its implication on servicing actions. To discourage such practice, change of control

can be triggered by an appraisal reduction amount (“ARA”)<sup>46</sup> instead of by actual loss occurrence. An ARA is an estimate of the amount by which a mortgage loan is undercollateralized. This estimate is predominately based on the underlying real estate collateral. The ARA eliminates the possibility of calculated delay in recognizing losses and allows asset pricing to be kept current with respect to market conditions. This appraisal will affect interest paid to the subordinate bonds as well. An appraisal is ordered when a loan is transferred to special servicing. Any impairment in value causes the interest paid on the subordinate bonds to be reduced. Interestingly, such mechanism was used in early CMBS transactions but was phased out over time.

“Using the impaired value to reduce the Directing Certificateholder's notional balance in the same way as realized losses would create a disincentive to defer losses. This mechanism will be unattractive to subordinate investors and may affect the price that they are willing to pay for the subordinate bonds.”<sup>47</sup>

The appraisal reduction mechanism is re-introduced in the new CMBS transactions. Another forthcoming control trigger improvement is the reduction of the number of below investment grade tranches. The logic behind this improvement is that the “thicker” the subordinate classes, the greater loss exposure the subordinate investors will sustain. This measure is aimed at better aligning the interest of subordinate investors with that of senior investors over the life of the transaction.

“In such transactions, the Directing Certificateholder will have a longer term perspective and have less incentive to defer losses because of concerns related to loss of control and potential transfer of special servicing.”<sup>48</sup>

Above all, the ARA will also act as a disincentive to subordinate bonds purchasers whose real motive is to gain control of the position of Directing Certificateholder.<sup>49</sup>

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<sup>46</sup> Appraisal reduction amounts have commonly been used in shifting control or triggering a change in payment terms in a split loan structure involving multiple promissory notes secured by the same mortgage instrument(s) encumbering the same real estate collateral or in a single-loan participation structure.

<sup>47</sup> (Berger, 2010)

<sup>48</sup> (Berger, 2010)

## **The discount rate used in net present value calculation**

The discount rate that the PSA spells out for the determination of a maximum NPV is the interest rate for a particular defaulted loan. Between the time of origination and default, market conditions have often changed drastically. Such rate is generally dated and cannot be inferred from current market conditions. If the discount rate is not specified, Specific Servicers would use the loan interest rate as the discount rate quite commonly. Again, such application of interest rate can be inappropriate with respect to market volatilities. Leading Special Servicers<sup>50</sup> agree that applying CMBS investor opportunity cost or the loan market rate would be most appropriate. Recognizing the need for a common and up-to-date benchmark, Commercial Real Estate Finance Council (“CREFC”) is proposing that the discount rate should reflect one of the two formulations:

- “The opportunity cost of funds for the CMBS Trust, collectively for all bondholders. This can be measured with the Barclays CMBS Index (or any successor index) weighted across credit categories; or
- The market rate of interest a successful bidder would apply if the asset that is being specially serviced were to be exposed for sale on a fair market basis. A proxy for this may be the discount rate used on a current appraisal of the asset.”<sup>51</sup>

## **Reporting of specially serviced assets**

Current PSAs do not mandate Special Servicers to provide the non-Controlling Class with an analysis of alternatives and decisions regarding asset resolutions. Only the Directing Certificateholder has the right to appoint a Controlling Class representative to review, critique and approve the Special Servicer's asset business plans and resolution strategies on an asset by asset basis. Asset valuation and the assumptions and financial analysis supporting the resolution alternatives often contain privileged and sensitive information. Another justification to the non-

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<sup>49</sup> (Kaye Scholer LLP, 2009)

<sup>50</sup> CWCcapital, and Midland.

<sup>51</sup> (A Discussion Document from the CMBS Investment Grade Bondholder Forum, 2010)

disclosure practice is to prevent the potentially overwhelming inquiries or even challenges from different investors. Therefore, Special Servicers are mostly reluctant to disclose information even after a resolution is concluded. Such information opaqueness leads to senior investors' questioning of the Special Servicer's motives.

Currently, the Investor Reporting Package ("IRP"), a standardized report in a common format among all servicers, delivers on-going transactional information to investors. However, the IRP's information on specially serviced assets is rather lacking due to the quality of reporting by Special Servicers. Acknowledged this as a significant CMBS market issue, CREFC is exploring the following initiatives that can enhance on-going investor reporting and transparency:<sup>52</sup>

- IRP: servicers and Trustees should contractually agree to provide investors with a complete IRP;
- Property financials: a quarterly financial report for each property should be available with a lag of no more than 3 months. Essential information consists of servicers' calculation methodology, all the debt payments serviced by the property in and outside the Trust, and the corresponding debt service coverage ratios. Lenders' identity, loan balance, and a summary of the payment terms for each loan should also be disclosed;
- Asset resolution information: for any specially serviced loan the servicer should provide the Operating Advisor with a business plan that includes the following:
  1. Full appraisal report;
  2. NPV calculation & assumptions;
  3. Loss expectation along with assumptions and terms as a result of loan modification;
  4. Detailed schedule of servicing fees from the Trust and other sources;
  5. Upon resolution of the special servicing situation, the operating advisor should report to all certificate holders what course of action was taken by the special servicer, and why that was the best course for the collective good of all certificate holders.
- Investor registration: the Trustee, in collaboration with the Custodian, should maintain a current list of investors in each transaction, to be updated at least monthly. The Operating

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<sup>52</sup> (A Discussion Document from the CMBS Investment Grade Bondholder Forum, 2010)

Advisor will be entitled to request this list in order to contact investors for any action that may require a vote;

- Data repository: the Trustee should house all deal related documentation on its website, and should provide a web board or similar messaging mechanism to publicly channel responses to specific investor questions so as to adhere to fair disclosure requirements. The Trustee should receive all reports directly from the producing party, in order to avoid the current hand-off of reports that often results in under-reporting. Any revised documents should be hosted on this website, and the Trustee should clearly identify the addition of such revisions.

It appears that the proposed measures described above will better align the interests of different bondholders, enhance operational transparency, and establish an oversight on servicers' conduct.

This study advocates that prohibiting the Special Servicer from being affiliated with the Directing Certificateholder is not only viable but is the only solution that can effectively eliminate the agency risk in the servicing structure, despite the market practitioners' concerns that such prohibition may "douse" the participation interest from the B-Piece investors.

Proposing such a significant change at a time when the B-Piece investors are still reeling from their losses and the general market is anemic is certainly not conducive to the restart of the CMBS market, but may be in the best interest of the market in the long-run. After all, the CMBS B-Piece is no different than a corporate junk bond with which the junk bondholders have no say on the debt restructuring. Still, junk bonds are well received by investors. Both the B-Piece and junk bond are high-risk-high-return investment vehicles for sophisticated risk takers. In an efficient market, the risk takers price in their investment exposure accordingly. If the lack of Directing Certificate is perceived as a risk, the next wave of B-Piece investors will naturally price their investment consistent with the new servicing structure.

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