

# REAL ESTATE MONITOR

THE NEWSLETTER OF THE BDO REAL ESTATE INDUSTRY PRACTICE



## RESIDENTIAL REAL ESTATE: MAKING MODIFICATIONS WORK

By **Brian Bader**

**L**ew Ranieri, often credited with creating the mortgage-backed securities industry when he was at Salomon Brothers in the early 1980s, has returned to try to save America from the worst effects of that accomplishment. In 2008, Ranieri established the Selene Residential Mortgage Opportunity Fund, raising money primarily from foundations and pension funds, to buy and restructure failed mortgages created to feed the securitization process. In doing so, he is showing how mortgage modifications can work – and why the federal home-owners modification program (HAMP) has done so poorly by comparison.

Selene focuses on two elements of the workout process that HAMP, and most servicers, have been unwilling or unable to implement. The two are (1) individualized

consultations with borrowers to see what each can afford – and how committed they are to home ownership and (2) principal write-downs to the point where borrowers have equity in their homes. Most mortgage modification programs have been loath to write down substantial amounts of principal because of concerns about the reaction of the investors who hold the mortgages and because of the risk of “moral hazard” (that once borrowers see that default can lead to debt forgiveness, even more will choose to default).

Selene avoids both these problems by buying portfolios of defaulted loans. With no MBS investors looking over its shoulder, Selene does not need to worry about the restrictions of a Pooling and Servicing Agreement. And having purchased the mortgages at a hefty discount, typically 40 to 50 percent of face value, it can afford to offer substantial principal reductions and still prosper. And Selene is willing to purchase not just defaulted

► Read more on page 6

## CONTENTS

<b>Residential Real Estate:</b>	
Making Modifications Work . . . . .	1
<b>CMBS:</b>	
Special Servicers . . . . .	2
<b>Securitization:</b>	
Covered Bonds . . . . .	3
<b>Leases:</b>	
Subordination Clause Could Harm Tenants . . . . .	4
<b>Legal View:</b>	
Second Circuit Rejects Champerty Defense . . . . .	5
<b>Migration:</b>	
Major Shifts . . . . .	6

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# CMBS: SPECIAL SERVICERS

By John Tax

Special servicers are the firms trying to correct mortgage loans in the later stages of delinquency or in actual default. Their role has become increasingly important as a result of the tremendous number of troubled loans. According to a report by Standard & Poor's (S&P), servicers have been training their staffs to address the unique aspects of these loans, packaged as commercial mortgage-backed securities (CMBS). Almost 50 percent of these unresolved assets are loans originated in 2006 and 2007. Many of the loans are more complex than older ones, which mean it takes longer to resolve them, either by a full workout, a discounted payoff or foreclosure sale. Because of the time period in which they originated, many of the newer loans lack some of the safeguards present in the commercial loans originated before 2004.

For example, says the report, pre-2004 loans are likely to have lower loan-to-value ratios than newer ones. Consequently, borrowers in those years are likely to have more equity in their collateralized properties due to principal amortization and other underwriting elements. These borrowers are more likely to protect their investments and may be better positioned to weather the current downturn. On the other hand, borrowers with newer vintage loans have different factors to consider if refinancing is not an option or their equity has been diminished. Newer vintage loans, particularly those issued in 2006 and 2007, often have more complex debt structures and tend to have larger balances. As a result, more of these loans are breaching performance levels that require transfer to special servicers familiar with the specialized processes needed to work out nonperforming assets.

## ► LOAN CHARACTERISTICS

The S&P Report says the characteristics of loans issued at different points in the economic cycle are likely factors driving their performance over time. Loans issued more than five years ago generally have stronger track records of performance before causing a breach that transfers a loan to special servicing. On average, through mid-year 2009, older loans performed for an average of eight years before defaulting or tripping another special servicing trigger. That time



frame drops to 3.4 years for newer loans. The ratio of newly transferred problem loans to resolution has steadily increased since 2007. As a result, S&P expects the number of new loan transfers to special servicers to remain high as unresolved asset inventories remain concentrated with newer vintage assets. S&P also expects future resolutions to involve more discounted payoffs (DPOs) and foreclosures than full payoffs. As reported last year, full payoffs declined to less than 20 percent of all loan resolutions, while the number of DPOs and foreclosures was climbing.

Special servicers may face more competition in recruiting and hiring qualified personnel. A number of special servicing companies have announced packaged pools as an alternative exit strategy. To conduct loan pool sales, special servicers typically use a sealed bid method to obtain offers, although they may opt to use an auction in some cases. Special servicers also may hire external firms to assist them; this could help reduce asset manager workloads. In seeking new servicers, S&P generally looks more favorably on those with a consistent track record of handling and resolving a steady flow of complex assets.

## ► HIGH VOLUME

According to the real estate data from Trepp LLC, delinquent CMBS that totaled to less than \$20 billion in October 2008 mushroomed to \$55.2 billion at the end of November 2009. The volume of delinquencies could reach

\$90 to \$100 billion this year. As a result, it is very possible that there will be an increasing number of defaulted loans being resolved one way or another. By one account, about 60 percent of maturing commercial mortgages last year were given one-year extensions. Underlying the problem of resolving such defaults is the fact that property values have fallen 43 percent across the board.

## ► LIQUIDATION ALTERNATIVES

A special servicer generally can utilize one of two different workout strategies. One is a sale or liquidation of the assets and the other is working with the borrower so that the property need not be sold. The first of these alternatives is most often the one chosen. In practice, the special servicer may be obliged to utilize the method prescribed in the servicing agreement established in the CMBS trust.

The servicing standard generally requires the special servicer to execute the strategy that gives bondholders the highest recovery on a net present value basis. Alternatives may be foreclosure, restructure, workout of note, or sale, whichever yields the highest recovery on a net present value basis.

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# SECURITIZATION: COVERED BONDS

By Anthony La Malfa

## THE USE OF COVERED BONDS AS A SOURCE OF HOME-MORTGAGE FUNDS IS BEING ENCOURAGED BY THE U.S. TREASURY DEPARTMENT AND THE FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) BECAUSE THEY OFFER MUCH GREATER CERTAINTY FOR THE BONDHOLDERS WITH RESPECT TO DAMAGES AND RIGHTS.

Covered bonds contain a key element that is missing in many commercial mortgage-backed securities (CMBS), i.e., a double layer of protection for investors, with the asset being backstopped by the issuer of the securities. The key difference between CMBS and covered bonds is that the latter requires lenders to retain the default risk. On the other hand, covered bonds fail to provide a good option for private labels because they require a capital base to retain loans on balance sheets and do not provide the higher level of leverage that was available with CMBS.

Simply stated, covered bonds are recourse debt obligations of an insured depository institution (M1). The bonds are secured by a dedicated pool of mortgage loans known as a "cover pool". Although covered bonds have been widely used in Europe, only two banking institutions appear to have issued such bonds in the U.S., according to the Treasury, which said it was looking for ways to increase the availability and lower the cost of mortgage financing to accelerate the return of normal home financing and refinancing activity.

### ►COVERED BOND-MBS COMPARISON

Covered bonds, issued by banks and other depositories, are collateralized by a pool of residential mortgages, but they differ in a number of ways from traditional mortgage-backed securities (MBS). Whereas mortgages packaged and sold to investors through MBS

usually are removed from the issuer's balance sheet, mortgages in covered bonds must remain on the balance sheet of the lender, thus tying risk to those responsible for issuing the bonds. The cover pool securing the bonds consists of a portfolio of actively managed residential mortgages that exceeds the amount of the bonds. If any of the mortgages in the pool become non-performing, they must be replaced by the issuer of the bonds.

Although the bondholders have a security interest in the mortgage pool, they receive payments from the issuer's general cash flow, rather than simply receiving pass-through payments on the underlying mortgages. Also, in the event of an issuer default, if the pool is insufficient to redeem the bonds at par, bondholders retain an unsecured claim on the issuer along with other unsecured creditors. Under Treasury's best practices policy, covered bond issuers could be either depository institutions and/or their wholly owned subsidiaries, or a newly created, bankruptcy-remote special purpose vehicle. Under either of these structures, the cover pool would be owned by the depository institution, and its assets and liabilities would be clearly identified on the institution's books. Covered bonds could account for no more than four percent of an issuer's liabilities (inclusive of the bank's), and each covered bond would have to have a specified investment to prevent acceleration of the bond in the event of the issuer's insolvency.

### ►COLLATERAL

Collateral in the cover pool would have to be first-lien one-to-four-family mortgages underwritten with documented income of the borrower and, for adjustable-rate mortgages, at the fully indexed rate. The maximum loan-to-value ratio for a mortgage in the pool would be 80 percent, and negative amortization would not be permitted. Mortgages would have to be current when added to the pool, and any mortgages that become more than 60 days past due would need to be replaced. Issuers at all times would need to maintain over-collateralization of at least five percent of the outstanding principal balance of the bonds. Issuers would need to perform a monthly asset-coverage test to ensure the quality of the collateral and the proper level of overcollateralization and make any necessary substitutions in the pool.

### ►CONCLUSION

It should be noted that while the use of covered bonds could help stabilize the U.S. home-mortgage market, most private analysts do not view covered bonds as a cure-all for the many problems facing the market, especially in light of the rating methodology recently published by Standard & Poor's for covered bonds. Because the U.S. does not have covered bond legislation or a proven tax record for the bonds, S&P has proposed to place covered bonds in the highest risk category. This may change if new legislation is enacted. Nevertheless, covered bonds may become a powerful source of liquidity in mortgage markets because they offer a unique combination of stability and return.

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## LEASES: SUBORDINATION CLAUSE COULD HARM TENANTS



By David Tevlin

Commercial lease agreements often are long and complex, with clauses neither party may expect will ever be triggered by events. But sometimes they are. One such is the lease subordination clause, by which the tenant agrees the lease is subordinate to any present or future mortgage that the landlord may put on the property. Accordingly, foreclosure of a mortgage (depending on the law of the state involved) either will automatically terminate the lease or entitle the lender, at its option, to terminate the lease.

Tenants who enter into leases at market rentals often assume (when they think about the problem at all) that foreclosing lenders will be happy to keep them as tenants. This may not be the case, however, where a tenant has received extensive concessions in the form of free rent periods or desirable renewal options—a common situation in today's over-supplied marketplace. As a result, a tenant who may have spent a large sum in fixturing commercial space might be put out of business because the landlord failed to pay the mortgage or might be forced to re-negotiate the lease.

A new lease is subordinate to existing mortgages because the general rule in law is "first in time, first in right". A landlord wants the lease to be subordinate to future mortgages as well because this eliminates a potential problem when future financing is sought. A tenant leasing a small amount of space in a building and who spends little money on leasehold costs will usually be unable to eliminate the subordination provision. However, a major tenant prepared to invest a substantial amount is in a much stronger bargaining position. The tenant should seek protection with a non-disturbance agreement (sometimes called a recognition agreement). Such an agreement provides that so long as the tenant is not in default under the lease, a foreclosing lender will recognize the lease and permit the tenant to remain in possession of his space.

### ►NON-DISTURBANCE AGREEMENT

If the property is mortgaged at the time the lease is entered into, the tenant should seek a non-disturbance agreement from the lender. With respect to future mortgages, the lease should contain no subordination provision (in which case it maintains its priority over future mortgages) or should provide that future subordination will be conditioned on

a non-disturbance agreement by the lender. A lender may be willing to give the tenant a non-disturbance agreement if certain conditions are met if and when the lender takes possession of the property following a default by the landlord. Typically, these include the following:

- The lease has not been modified by the landlord without the approval of the lender;
- The lender will not be liable for any unperformed obligations of the landlord;
- The lender will not be obligated to make any payments promised by the landlord (e.g., a cash bonus) or be obligated to recognize any rent prepayments by the tenant.

In addition, the lender may insist that if and when it takes over the space, the tenant's rent will remain unchanged only if an independent appraiser certifies that the amount reflects the fair rental value of the property. This meets the main objection to a non-disturbance agreement by a lender—that the agreement may prevent space leased at below-market rentals to be re-leased at market rates.

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## LEGAL VIEW:

# SECOND CIRCUIT REJECTS CHAMPERTY DEFENSE

By Alvin Arnold

ChamPERTY is not a word often heard these days, even though it is a living doctrine in modern law and on occasion has real bite. In a recent case, the Second Circuit Court of Appeals reversed a trial court ruling that had dismissed a mortgage trust's suit for indemnification for loan losses from the originator. Trust for Certificate Holders of Merrill Lynch Mortgage Investors v. Love Funding Corp., 391 F.3d 116 (C.A.2, N.Y.). However, the reasoning of the decision leaves some room for the distressed debt markets to be concerned.

Love Funding was the originator of a \$6.4 million loan on a Louisiana apartment complex, funded by Paine Webber Real Estate Securities, Inc. Paine Webber included the loan as one of 36 sold to Merrill Lynch Mortgage Investors, Inc., in late 1999, which Merrill Lynch, in turn, assigned to the Trust for securitization. Love Funding and Paine Webber had each, when selling the loan, represented the loan was not then in default and provided an indemnification against any losses suffered on account of a breach of representations.

In 2002, the loan went into default, and a Louisiana court determined the borrower

had secured the loan by fraud. The fraud, in turn, meant the borrower had been in default since the loan was originated – thereby breaching Paine Webber's and Love Funding's representations.

The Trust then sued UBS (Paine Webber's successor) on account of the loan, among others. The litigation was settled in 2004 with the Trust returning 33 loans to UBS. UBS paid \$19.375 million for 32 of the loans. However, the sole consideration for the loan at issue in this case was an assignment of UBS's rights under the original mortgage loan purchase agreement with Love Funding. The Trust then commenced this suit for breach of representations against Love Funding.

## ►DISMISSED AS "CHAMPERTOUS"

The federal district court granted UBS summary judgment on the breach of representation claim. However, it then allowed Love Funding to amend its answer to assert chamPERTY as a defense, and dismissed the suit on that basis. According to a New York statute, "no corporation or association . . . shall solicit, buy or take an assignment of . . . a bond, promissory note, bill or exchange, book debt, or other thing in action, or any claim or demand, with the intent of bringing an action or proceeding thereon." The court found that the Trust had carved out this one loan in order to acquire the lawsuit against Love Funding, from which it expected to be able to recover more than it could recover from UBS, and that the suit was therefore chamPERTOUS.

## ►CERTIFICATION TO THE NEW YORK COURT OF APPEALS

On appeal to the Second Circuit Court of Appeals, the court certified questions on the interpretation of the chamPERTY statute to the New York Court of Appeals. The Court of Appeals accepted the certification, and in its ruling emphasized that chamPERTY "has always been limited in scope and largely directed toward preventing attorneys from filing suit merely as a vehicle from obtaining costs". Acquiring a thing in action in order to obtain costs is chamPERTOUS, while acquiring it to protect an independent right of the assignee

is not. For example, it is not chamPERTOUS to acquire a debt instrument with the intent to collect on it by litigation. Noting that the Trust had a preexisting interest in the loan that underlies the breach of representation claim, the court states that if the Trust took the assignment of the cause of action to enforce its rights, that was not chamPERTOUS under New York law.

With this clarification in hand, the Second Circuit held the evidence adduced could not support a claim of chamPERTY. Love Funding urged that the case be remanded to the trial court for a factual determination on the Trust's intent in acquiring the cause of action. According to Love Funding, the assignment amounted to chamPERTY even under the Court of Appeals ruling because the Trust's intent was not to enforce its rights under the indemnification, but to "engage in a speculative litigation venture against Love Funding to generate and recovery costs and damages far greater than its actual losses on the loan." In support, it pointed out the Trust had originally estimated its loss on the loan at \$3 million, but that it was demanding in its suit that Love Funding repurchase the loan for \$10 million. The court, however, found no basis in the evidence to support a claim that the "Trust's intent was to employ litigation to profit from the costs and fees generated therein" rather than to recover the full value of its contractual claims. Accordingly, the Second Circuit remanded for entry of judgment in favor of the Trust and a calculation of damages.

## ►OBSERVATION

This case may raise concerns for purchasers of distressed debt. While the court noted in dicta that it is not chamPERTOUS to acquire a debt instrument with the intent to collect on it through litigation, the actual decision seems to rely heavily on the fact that the Trust had a pre-existing interest in the loan and a claim against UBS, and acquired the rights against Love Funding to vindicate those interests. A third-party purchaser, however, would have no preexisting interest and would be unable to make such an argument.

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# MIGRATION: MAJOR SHIFTS



By Andrew Dalecki

Every type of real estate – housing, business, retail, and office – is impacted by population movements across the U.S. and across its borders. In its most recent report, based on new Census numbers, the Brookings Institution says the past ten years saw the greatest migration slowdown since the end of World War II. Significant events were the housing bubble and the worst recession in more than half a century, as well as major storms and terrorist attacks.

The most recent Census numbers reflect population shifts through mid-2009. The most dramatic story is the decline of Florida as the nation's migration magnet. Florida led all states in domestic in-migration in each of the first five years of the past decade, then falling down to 44th and 45th in each of the last two years. In that two-year period, Florida lost more migrants than it gained for the first time in recent history. Next in line was Nevada which showed a migration loss in 2008-9,

while Arizona gained only 15,000 migrants in that period compared to 132,000 in 2004-5.

## ►POPULATION GAINERS AND DONORS

The Brookings Report states that among the 17 Sunbelt states with the greatest migration gains in 2005-6, the last year of the housing bubble, all but 4 (Texas, Virginia, Washington and Colorado) registered the lowest migration gains in each of the next three years. Texas is the most prominent Sunbelt survivor of the last half of the decade. The state was the domestic migration leader in each of the past four years. The other side of the migration equation was states including New York and California that were major contributors to the Sunbelt surge. Much of New York's loss of new migrants was Florida's gain, while much of California's loss meant gains to Arizona and Nevada.

The report notes that the new figures showed noticeable declines in immigration over the past three years, a result of the economic downturn that even caused some immigrants to return home. The 2008-9 net international migration figure of 855,000 was the lowest since 2002-3. The report says that when housing and job markets eventually recover, so will migration recover to levels and to destinations more in keeping with the recent past. But the boom and then bust' decade of 2000-2010 will leave some scars, both economic and political, that will not soon be forgotten.

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►CONTINUED FROM PAGE 1

## MAKING MODIFICATIONS WORK

loans, but also REO (bank real-estate owned) properties. Selene recently purchased approximately 1,000 residential properties from Taylor, Bean & Whitaker's bankruptcy estate for roughly \$80 million.

## ►PROFIT PROSPECTS

Of course, Selene will never turn a profit if the default rate on modified loans is comparable to those in the government backed-modification programs, which often experience re-default rates of 50 percent or more. To avoid this problem, Selene indicates that its intent is to focus on borrower characteristics that predict loan performance; not just employment and income, but also commitment and motivation. According to a recent profile in Fortune magazine, one important indicator is the borrower's contact record from the prior servicer. Borrowers who made repeated and determined efforts to contact the servicer in order to save their homes are less likely to default if the loan is properly restructured. Borrowers who showed a less committed attitude are poorer candidates for a workout.

What is still unclear is the extent to which the broader loan-modification-industry could learn from Selene's approach. Taking a 50 percent write-down to turn a default into a performing loan is not a particularly rousing success. And it is still unclear to what extent Selene's successes will pan out over the long term, and whether the success it does achieve is due to its ability to cherry-pick the loans it is willing to buy, leaving more problematic loans and troubled borrowers for others to deal with.

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