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Strategic Defaults in CMBS Loans and Special Servicing

It is no news to anyone that many owners of commercial real estate have outstanding loans that are approaching maturity, or are on the brink of (if not in) default. To make matters worse, we have an economy in which the opportunities for a sale or refinancing are still thin. Borrowers wanting to renegotiate their debt are sometimes finding the lenders themselves are in distress and simply are not picking up the phone. The problem of getting to the finish line (or even the starting line) for a loan modification can be particularly acute if the loan is a CMBS loan. In the case of securitized debt, the business relationships forged with the lending professionals at the originating bank are of little value, as the borrower has to deal with an often hard-to-reach servicer that may have only limited or no ability to agree to a modification of the loan (and may know little or nothing about the underlying property).

In this environment, an increasing number of owners are electing to let their loans go into default as a strategy intended to move the loan into the domain of "special servicing." The hope is that special servicing – which may be performed by a division of the pre-default master servicer but more typically is performed by a specialized servicer unrelated to the servicer handling a performing loan – may provide the servicer with additional tools and flexibility to "cut a deal" with respect to a distressed loan (the pre-default master servicer is generally contractually forbidden from agreeing to any material loan modifications). The trend has been particularly noticeable in the hotel market in California; according to [GlobeSt.com](#), at least a dozen hotels in California have employed this "default of convenience" strategy. Several of these hotels are owned by affiliates of large, well-known, companies. One such company – Millennium Partners – issued a statement regarding its default under the CMBS loan for the Four Seasons San Francisco, saying that it had "strategically withheld payment of debt service," adding that "[c]onversations on restructuring the debt have begun and Millennium Partners is hopeful that they will result in a positive outcome" (San Francisco Business Times, July 8, 2009).

While this approach may seem radical to some, it has grown out of the frustration that many owners have felt in attempting to get lenders' attention in dealing with the new economic realities of the world.

It is, of course, vital that an owner considering taking this approach do so with its eyes fully open.

The borrower should do all that it can to diligence whether or not its default *will* actually result in the imposition of special servicing – it would be unfortunate to say the least if a borrower defaulted as a strategic move, only to find that nothing has changed vis-à-vis the servicing of the loan. While most CMBS pooling and servicing agreements require that a monetary default be outstanding for a

specified period of time (typically 60+ days), generally the loan is required to be transferred to special servicing when the master servicer or the special servicer becomes aware that the borrower is in imminent risk of defaulting (monetary or otherwise) and it is not likely that the default will be cured within 60 days. But, given the high degree of variation among CMBS pooling and servicing agreements, the special servicing transfer provisions should be carefully evaluated.

In addition, there are threshold considerations that must be evaluated – such as, for example: the potential for recourse liability to guarantors or other credit parties, the effect on third parties (*e.g.*, the impact under management and/or franchise agreements), and the tax implications of the various possible outcomes. It is important that all of the facts and circumstances, and the terms and conditions of the governing loan documents, be properly reviewed and analyzed before taking this step.

Sometimes, with a bit more creativity and with somewhat less risk, a borrower may “threaten” to default without actually defaulting to achieve the desired result (*i.e.*, taking actions such that the servicer “becomes aware that the borrower is in imminent risk of defaulting”); however, of course, this may not be as effective in achieving the desired result of getting the servicer’s attention.

If you have a need for legal advice on any of the above matters, please contact any of the following partners in our [Distressed Real Estate](#):

[Bruce M. Stachenfeld](#)

Co-Chair

Distressed Real Estate

Practice Group

(212) 692-5550

bstachenfeld@dslip.com

[Terri L. Adler](#)

Co-Chair

Distressed Real Estate

Practice Group

(212) 692-5533

tadler@dslip.com

[Kirk L. Brett](#)

Co-Chair

Distressed Real

Estate Practice Group

(212) 692-5525

kbrett@dslip.com

[Allan N. Taffet](#)

Co-Chair

Distressed Real

Estate Practice Group

(212) 692-5523

ataffet@dslip.com

Please contact Caitlin Velez at (212) 672-3747 or newsletter@dslip.com with any questions or comments.

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