

Master Servicers and Special Servicers: A Basic Overview

*Mitchell S. Kaplan and Arren S. Goldman**

The authors of this article provide an overview of how commercial backed mortgage securities or “securitized” commercial mortgage loans are serviced.

Whether you are an existing commercial backed mortgage securities (“CMBS”) borrower, you are gearing up for a new CMBS loan closing or you are about to assume a CMBS loan, the CMBS loan servicing world frequently can be a complex field to navigate. Accordingly, it is important that borrowers and their counsel have a general understanding of how CMBS or “securitized” commercial mortgage loans are serviced.

Pooling and Servicing Agreements or Trust and Servicing Agreements (“Servicing Agreements”) govern the servicing of securitized loans. If a mortgage loan has been pooled with other mortgage loans, it will be serviced pursuant to a Pooling and Servicing Agreement. If a mortgage loan has been securitized in a single asset securitization, it will be serviced pursuant to a Trust and Servicing Agreement. A master servicer and a special servicer will, among others, be parties to a Servicing Agreement, and each will have a distinct role thereunder.

General Overview of Master Servicer and Special Servicer Roles; The Servicing Standard

Servicing Agreements require servicers to service CMBS mortgage loans according to the “servicing standard.” In general, this means that each servicer is to service the applicable loan or loans in the same manner, and with the same care, skill, prudence and diligence which a similar servicer would administer similar loans for third parties. Additionally, the servicing standard is based upon how a prudent institutional commercial lender would customarily service its own loans.

Under the servicing standard, a servicer must always act with a view towards timely collection of payment of principal and interest and other amounts payable under the loan or, if a loan is in default, in a manner that will maximize the recovery on the loan to the bond holders. Applying the servicing standard, a loan is to be serviced objectively, without regard to any relationships that the servicer may have with any of loan obligors. Servicing a loan “objectively” also means that a servicer is to act without regard to the fact

*Mitchell S. Kaplan and Arren S. Goldman are partners in the Real Estate group in the New York office of Seyfarth Shaw LLP. Their practices are focused on financing, leasing, and conveyancing. The authors may be contacted at mkaplan@seyfarth.com and asgoldman@seyfarth.com, respectively.

that it or its affiliates may be a bond holder and without regard to the fact that it may be obligated to make certain monetary advances under a Servicing Agreement. Finally, consistent with the servicing standard, a servicer must also act without regard to its right to receive fees, reimbursement of costs or other compensation, and without regard to the ownership, servicing or management for others of any other mortgage loans by such servicer.

A master servicer frequently will have the right to enter into sub-servicing agreements consistent with the applicable Servicing Agreement, whereas special servicers generally are prohibited from doing so. If a master servicer enters into such an agreement, it will continue to be primarily liable to the bond holders for the sub-servicer's proper servicing of the loan pursuant to the terms of the applicable Servicing Agreement.

A master servicer will be responsible for the day-to-day administration of the loan, including, for example, the collection of payments prior to an event which triggers the transfer of a loan from the master servicer to the special servicer (hereinafter a "Special Servicing Event" – more on this below). Other administrative duties of a master servicer are likely to include the payment of real estate taxes if required by the terms of the applicable loan documents, the maintenance of payment records and the maintenance of insurance if a borrower fails to maintain insurance in accordance with the terms of the loan documents.

Additionally, a master servicer will exercise decision making powers of the "Lender" expressly contemplated by the applicable loan documents; provided, however, under certain circumstances the master servicer may have to first obtain the special servicer's

consent before it acts. A master servicer may also be required to advance payments to bond holders, subject to future reimbursement with interest, that would have otherwise been made to such bond holders if the applicable borrower had not defaulted.

As described in more detail below, in some circumstances, a master servicer will have the right/be required to make all decisions regarding a loan prior to a Special Servicing Event, without having to consult with the special servicer.

In general, a special servicer will become involved with a securitized loan when the "Lender's" consent under the loan documents is required and, as described in more detail below, when the requested action is a "Major Decision" or is not on a list of powers allocated to the master servicer. Additionally, as more fully detailed below, after certain defaults or, in some cases, after an anticipated default, a loan may be transferred from the master servicer to the special servicer, either for foreclosure or a loan workout, or possibly for the sale of the loan.

The compensation to be received by each servicer and the allocation of certain fees between the master servicer and special servicer is expressly set forth in the applicable Servicing Agreement, including the amount that a servicer will receive in connection with a loan workout.

Specific Examples of When a Borrower Can Expect the Special Servicer's Involvement

Specific Master Servicer Tasks and "Major Decisions"

Servicing Agreements often contain lists of specific tasks that a master servicer shall perform without input or consent from the

special servicer. If a Borrower is requesting an action that does not fit squarely on such list, the master servicer will have to obtain the consent of the special servicer to act. Other Servicing Agreements will achieve the same result by having a defined list of “major decisions,” and expressly provide that the master servicer must obtain the consent of the special servicer to make a major decision.

As noted above, certain Servicing Agreements will provide the master servicer with full discretion on all decisions prior to a Special Servicing Event, without the need to consult with the special servicer at all. These Servicing Agreements may nevertheless contain a major decisions list and, with respect to such major decisions, the master servicer will not have to obtain the special servicer’s consent, but will have to obtain no downgrade letters from the rating agencies that have rated the applicable bonds before making a major decision.

When a master servicer must obtain the consent of the special servicer, and the special servicer in turn must obtain the consent of the controlling class representative (i.e., a representative for the most subordinate class of bond holders), time frames for responses for each party are often detailed in the applicable Servicing Agreement. For example, a special servicer may have a specified number of days (e.g. 15 business days) to consent to, or reject, a request with respect to a major decision. During the specified period, the special servicer must work to obtain the consent of the controlling class representative, which will have a shorter period to consent or reject. Often, the failure of either to respond (i.e., the controlling class representative failing to respond to the special servicer or the special servicer failing to respond to the master servicer) will be

deemed an approval of the requested action. However, if a special servicer or controlling class representative requests additional documentation or information, the time periods for a “response” may be tolled and/or reset until it receives the requested information or additional documentation. Some Servicing Agreements will provide the master servicer with discretion to take certain actions immediately if necessary to protect the interests of the bond holders.

A master servicer and its counsel will provide a CMBS borrower and its counsel guidance in terms of the documentation required to process a consent request. The nature and extent of the required documentation will vary depending upon the nature of the request. For example, if consent is sought for the assumption of a loan by a certain party, detailed financial documentation regarding the assuming borrower, its key principal(s) and any substitute guarantor/indemnitor will be required.

Additionally, if the assuming borrower intends to replace the property manager, financial and other information regarding the property manager’s experience may be required. Furthermore, various opinion letters, copies of purchase/sale and conveyance documentation, an updated property condition report and organizational documents are likely to be required. All such documentation is not only used by the master servicer to underwrite an assuming borrower and to make a recommendation to the special servicer with respect thereto, but it is also used by the special servicer as part of its analysis of the consent request. Accordingly, after reviewing the documentation provided, a special servicer, as noted above, may request additional information, may seek clarification of certain information provided,

or it may impose conditions in connection with granting its approval.

The following are examples, although not necessarily an exhaustive list, of “major decisions” which likely would require special servicer consent:

- Any modification, consent to a modification or waiver of a “monetary term” or material non-monetary term in the loan documents. A “monetary term” may be defined as a change to the interest rate, to the principal balance, to the amortization term or payment frequency thereof, or to any provision requiring the payment of a prepayment premium in connection with a principal prepayment. The modification, consent to a modification or waiver of default interest and late charges are generally excluded from the “monetary term” concept, but the timing of payments thereof and the acceptance of discounted payoffs, are often included.
- The extension of a maturity date.
- The substitution of a property manager or a change to a franchise arrangement, in either case outside the parameters expressly permitted under the loan documents. Servicing Agreements may provide that a property manager substitution or a change to a franchise arrangement is not a major decision if a loan is under a certain specified threshold, such as having less than a certain outstanding principal balance.
- The release or substitution or addition of collateral. This provision may not be triggered in some circumstances for immaterial condemnation, but it likely will include partial releases of property and

the substitution of defeasance collateral, unless expressly contemplated by the loan documents with no lender discretion therefor.

- The waiver of a due on sale or due on encumbrance clause. Stated differently, the transfer of a property or any portion thereof, or a transfer of a direct or indirect interest in borrower, in each case except as expressly permitted without Lender’s consent as set forth in the loan documents. These provisions are often triggered with change of control (non-permitted equity transfer) transactions.
- Consent to a borrower incurring additional debt, or an affiliate of a borrower incurring mezzanine debt, or modification of the terms of any document evidencing such additional debt and any intercreditor or subordination agreement executed in connection therewith, and any waiver, amendment or modification thereof, if the lender’s consent is required in connection therewith.
- The release of escrows, reserves or letters of credit not expressly contemplated by the loan documents without lender discretion.
- A modification or waiver with respect to the type, nature or amount of insurance coverage a borrower is required to obtain and maintain. This category would include a requested change to the rating standards found in the loan documents for insurance carriers.
- Approval of casualty insurance settlements or condemnation settlements, and any determination to apply insurance proceeds or condemnation awards

to the reduction of the debt rather than rebuilding the property.

- Approval of major leases.

Special Servicing Event Triggers

Servicing Agreements will contain express provisions as to when a loan is to be transferred from a master servicer to a special servicer. As detailed below, some trigger events are clear and without discretion, while others may require a servicer to draw a conclusion with respect to a default or imminent default.

1. Events Triggering a Special Servicing Event and a Transfer of a Loan from a Master Servicer to a Special Servicer

Special Servicing Event triggers include, for example, a failure to make a monthly payment, with such failure continuing for a period of time, such as for 60 days. In contrast, some Servicing Agreements will provide that a failure to make, for example, two consecutive monthly payments will trigger a Special Servicing Event. Similarly, others will provide that if a servicer must make, for example, three consecutive advances to bond holders, a Special Servicing Event will have occurred.

Also, the failure to make a balloon payment likely will trigger a Special Servicing Event, but the transfer of the loan to a special servicer may be averted if an acceptable refinancing commitment is approved by the master servicer. An acceptable refinancing commitment may require, among other things, that the closing of the refinancing occur within a specified number of days from the date that the balloon payment was due.

Other Servicing Agreements will provide the master servicer or, in some cases, the special servicer, with the discretion to deter-

mine, in accordance with the servicing standard, that a failure to pay principal and interest is imminent or that an overdue payment is unlikely to be made prior to a specified time period, such as two monthly payment dates after a payment initially became due. In either case, if such a determination is made, the loan is required to be transferred to the special servicer.

A loan also may be transferred to a special servicer if there is a default (subject to the grace period provided in the loan documents), other than with respect to a monthly payment, if such default is determined to materially impair the value of the property or will materially, adversely affect the bond holders.

A Special Servicing Event can also occur if a determination is made, by the master servicer or, in some cases, the special servicer, that a default is:

- (i) reasonably foreseeable,
- (ii) would materially impair the value of the property or would materially, adversely affect the bond holders, and
- (iii) is likely to continue unremedied for the applicable grace period under the loan documents.

Insolvency-related Special Servicing Event triggers may include the issuance of an order or decree with respect to involuntary bankruptcy which is not dismissed within a specific period of time, a borrower consenting to the appointment of a receiver or conservator or liquidator, a borrower admitting in writing its inability to pay debts when due or the filing of an insolvency petition or a borrower making an assignment for the benefit of its creditors or voluntarily suspending payment of its obligations. Note that an involuntary

bankruptcy order that remains unremedied for 60 days, for example, may land a loan in special servicing, even if the loan documents provide that the borrower has 90 days before an “Event of Default” has occurred under the loan documents.

Master servicer’s receipt of notice of commencement of foreclosure of a mechanic’s or other third party lien with respect to the property may also cause the transfer of a loan from a master servicer to a special servicer. Some Servicing Agreements may provide a short time frame for a borrower to bond over the related lien which is being foreclosed, such as three days.

2. Curing a Special Servicing Event Resulting in the Transfer of a Loan from the Special Servicer Back to the Master Servicer

Once transferred to a special servicer, a loan does not necessarily have to stay with the special servicer for the duration of the term of the loan and it may be transferred back to a master servicer under certain circumstances. Following a payment default which triggered a transfer of the loan to the special servicer, Servicing Agreements typically provide that if the borrower subsequently makes three consecutive full and timely monthly payments and all prior defaults

have been cured, a loan will be transferred back to the master servicer. Similarly, with respect to other defaults, if the circumstances causing the default cease to exist in the good faith judgment of the special servicer, the loan will be transferred out of special servicing. For bankruptcy and insolvency related defaults, or the commencement of foreclosure proceedings, an order dismissing the proceedings likely will be required before a loan can be returned to a master servicer. It is noted, however, that additional fees will be incurred with transfers to and from special servicing, including a workout fee that the borrower likely will be expected to pay.

Conclusion

In summary, the roles of a master servicer and a special servicer will vary from Servicing Agreement to Servicing Agreement. The roles of each also will vary depending upon the specific provisions contained in the applicable Servicing Agreement as well as the status of the loan and/or the action sought by a borrower. When making a consent request with respect to a loan that has been securitized, CMBS borrowers and their counsel should seek to gain a full understanding about the precise roles of the master servicer and, as applicable, special servicer for their specific transaction.