

TITLE ISSUES

SECURITIZED LENDING IN A NUTSHELL

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Securitized lending is today's hot item in commercial real estate mortgage financing, but it isn't a new idea. Anyone who has invested in "Ginnie Maes" has participated in a securitized lending scheme. There are differences, one being that Ginnie Maes are limited, essentially, to pools of residential mortgages while the new securitized lending schemes involve commercial properties. However, these transactions all operate on funds derived from selling direct or indirect mortgage securities to the public.

A. Nature of the transaction.

Usually, in a group of several different partnerships, each owns a separate parcel of property, has a common general partner, and has mortgaged its own property in the past. Ordinarily, this mortgage is either an acquisition mortgage or the permanent financing of a construction loan which was used to build the improvements on the property. Each mortgage can be with the same lender or with different lenders. Usually, but not always, no partnership is responsible for the mortgage debt of its sister partnerships. If one doesn't pay, the lender's remedy is to foreclose on only that partnership's mortgaged land.

The next step is the creation of the REMIC bondseller, sometimes called the Funding Company. The term "REMIC" does not denote a thing; rather, it is an acronym for a provision of the federal tax laws meaning Real Estate Mortgage Investment Conduit. The Funding Company is usually a corporation, but it can also be a business trust. Its purpose is to sell securities to the public, which are similar to bonds. The principal and interest payments for these securities come from the mortgages which the Funding Company will either purchase or make.

Next, the Funding Company's securities are sold to the public or to the investment houses sponsoring the transaction, such as Goldman Sachs, Merrill Lynch or Kidder Peabody. The Funding Company uses the proceeds of the securities sale

either to purchase the existing mortgages or to pay them off and replace them with new mortgages. In either event, the mortgages are cross-collateralized and the cash flow from the loan payments is pooled.

Cross-collateralization makes each parcel of property security for all of the debt due under all of the mortgage loans now held by the Funding Company. This is accomplished in one of two ways. First, each of the partnerships may execute its guarantee to pay all of the other partnerships' debts and secure that guarantee with a mortgage. Alternatively, each of the partnerships may execute an indemnity mortgage on its property to secure the other partnerships' notes without undertaking any personal obligation for the other partnerships' debt. The result is that Property A can be foreclosed for a default on the mortgage on Property B, Properties B and C can be foreclosed for a mortgage default on Property C, and so on.

Mortgage payments are then pooled and the cash flow is applied to the payment of the securities. Usually, this is done by the Funding Company assigning it to a trustee for the holders of the securities, who distributes the cash in accordance with the terms of the securities. As additional security for the owners of the securities, the mortgages are usually collaterally assigned to the trustee as well. If the securities aren't paid, the trustee can foreclose the pledge and acquire ownership of the mortgage. Then it can foreclose the mortgage and sell the land to pay the debt.

The reason for the use of multiple properties, cross collateralization and pooling techniques is to spread the risk of nonpayment of the Funding Company's securities over many different projects. Properly done, this limits the damage done by the financial difficulties of any one project. It also provides greater security in the event of foreclosure since the value of each property in excess of its own debt is available to cover shortfalls in value of the other properties.

The Funding Company's securities are in various grades, each

with a different interest rate. The highest grades have the first call on the cash flow from the mortgage pool and the lower grades have increasingly junior claims. Because the risk of default is greater for the holders of the lower grade securities, the lower the grade, the higher the interest rate. For example, suppose the following case: The aggregate of all mortgage payments required to be made each month is \$1 million. There are four classes of securities: A, B, C and D, each requiring the aggregate payment of \$250,000 each month. The highest grade securities have the highest priority claim on the cash actually received by the trustee each month. Under this scenario, if for some reason defaults left the trustee with only \$800,000 in one month, all but the Class D security holders would receive their full payments. This is similar to what often happens to junior lienors in judicial mortgage foreclosures where the real estate has insufficient value to secure all of the debts of its owner. Because the risk of default is greater for the holders of the lower grade securities, the lower the grade, the higher the interest rate.

Just how high is the risk of nonpayment? The risk factor of each grade of securities is determined by a rating from one of the rating agencies such as Standard and Poors, Duff & Phelps or Moody's, and depends on the factors involved in the transaction. The rating amounts to the agency's educated guess of the probability of full and timely payment of each of the mortgage debts compared to the priority of payment required by each of the security grades. This rating, and the activities of the bond houses creating the product, make these securities marketable investments similar to corporate bonds.

B. Motivation for the transaction.

The interest in this kind of financing results from the current difficulties faced by the traditional sources of real estate finance capital and the necessity of getting existing loans refinanced. A large percentage of the savings and loans in the country have been seized by the Resolution Trust Corporation and are no longer making loans. Many of those that are still solvent have too much of their loan portfolio invested in real estate already. Life insurance companies and pension funds have been so adversely affected by the poor performance of many of their real estate loans that they are generally unwilling to invest much more.

Securitized lending offers several advantages. Many institutional investors that will not make real estate loans will invest in marketable securities, including these. The yields to the investors are higher than those from other relatively safe investments. Finally, the interest rates paid by the borrowers are generally lower than what they could otherwise obtain, even taking into account the high initial costs in the form of fees to the attorneys and bond houses who create these sophisticated packages.

C. Real estate title issues.

The cross-collateralization that makes these transactions safer for the investors creates two title issues: Creditors' rights and validity of each of the mortgages.

1. Creditors' rights.

The creditors' rights issues arise when different entities own each of the properties which are being mortgaged. Because investors in real estate desire limited partnerships, the preferred vehicle for the ownership of investment properties, the general pattern seems to be that a developer will form limited partnerships in which it is the general partner and diverse investors are the limited partners.

However, each limited partnership is a different legal entity with its own creditors. The cross-collateralization process effectively has each partnership guaranteeing the debts of the other partnerships. Those creditors could be hurt if any one of the partnerships is insolvent or doesn't have sufficient capital to continue in its business after the securitized loan transaction is completed. The question will be, "Did the partnership get reasonably equivalent value for its guarantee of the other partnerships?" If not, its mortgage may be a constructively fraudulent transfer which could be set aside if it subsequently files bankruptcy¹. Given the uncertain status of the law on the valuation of contingent guarantees, this is a difficult question to answer².

2. Validity of each of the mortgages.

The validity of the mortgage on any property in the pool may be questioned when the consent of all partners of the partnership owning it cannot be had. Sometimes such universal consent is not easy to get. Obtaining it may be especially difficult when there are great numbers of limited partners with small interests. Many may feel that responding is simply too much trouble. Others may be unsure of the nature or consequences of the transaction which is being proposed. It is also possible that some may actively dislike the new transaction, as would partners in partnerships which have more equity than those with which they are being cross-collateralized.

Partnership law makes each partner the agent for the partnership for matters which are apparently within the usual scope of the partnership's business³. Without the consent of all partners, the mortgage would bind the partnership property only if the partners signing it were agents of the partnership for that purpose. However, guaranteeing the debt of a related partnership that is probably not in the usual scope of business of a partnership that owns and operates an apartment building⁴. It is likely there will be a problem unless the partnership agreement clearly provides for this kind of action by the general partners alone or with the consent of some percentage of the limited partners.

D. Attempted solutions.

Attempts have been made to solve both problems by having each of the different partnerships convey its property into a single, newly created partnership. Each gets a partnership interest in that new partnership as consideration for its transfer. The new partnership then makes the mortgages. They are executed by all of the partners of the new partnership.

This may not work for the following reasons:

First, all of the partners of each of the old partnerships would have to consent to their partnership executing its deed to the new partnership. Why? Because such a transfer probably is no more in the ordinary course of the partnership's business than the cross-collateral guarantee they are trying to avoid. So, without the consent of all, the new partnership might not have the quality of title necessary to make the mortgages on the land that will be pooled.

Second, the creditors' rights problem is changed but not eliminated. Now the question would be, "Is the interest in the new partnership which each of the old partnerships received substantially equal in value to the equity in the real estate that each transferred to it?" If not, and the Funding Company issuing the securities or the trustee knew the economics of the transaction, both the deeds and the mortgages might be imperiled in a bankruptcy setting.

NOTES

1. 11 U.S.C. 548; *Rubin v. Mfrs. Hanover Trust Co.*, 661 F.2d 979 (2nd Cir. 1981).

2. U.S.C. 548; *Matter of Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988). The court states that contingent guarantees cannot be deducted at face value to determine solvency but it gives no other rationale for valuing them.

3. Uniform Partnership Act, Sec. 9(1) and 9(2), CA 9-301; Uniform Limited Partnership Act, Sec. 9(1); Revised Uniform Limited Partnership Act, Sec. 403(a), CA 10-403.

4. See, *Chelsea National Bank v. Lincoln Plaza Towers Associates*, 461 N.Y.S. 2d 238 (N.Y. 1983) where the New York Court of Appeals stated the authority of a partner to bind the partnership for obligations of 3rd parties had to be found in the partnership agreement or be shown to be inherent in the partnership business. Analogously, *In re Fox Hill Office Investors, Limited*, 101 Bankr. 1007 (W.D. Mo. 1989) found, *inter alia*, that the debtor partnership's mortgage securing a loan made to its parent was not for any partnership purpose. Therefore, it held that the debtor partnership was not obligated on the loan due to the lack of authority of the general partner to make it.

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