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Owners of CMBS mortgage encumbered properties: Beware of lessons learned

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We learned a lot about commercial mortgage backed securities (CMBS) loans, and the servicing companies that held them, when the Great Recession resulted in widespread commercial mortgage loan defaults.

The limited recourse provisions of some of those loans were used by some mortgagees to gain leverage in ways that borrowers could never have anticipated.

Lessons learned during that period bear remembering, as the commercial real estate industry is, again, under tremendous strain due to the COVID-19 pandemic.

As the economy reopens, commercial landlords and

tenants will seek financial safety as losses begin working their way through the economy. Without income, tenants are looking for financial relief. No doubt, many rental concessions will be negotiated to keep tenants open and paying rent. For owners of commercial properties encumbered by CMBS loans, the calculus for giving tenants rent relief is fraught with peril.

CMBS loans are generally non-recourse, except to the extent of certain exceptions; those exceptions — or carveouts — are typically guaranteed by one or more of borrowers' principals. The carveouts fall into two categories: (i) those for which liability is limited to the extent of any loss or damage incurred by the lender, and (ii) springing-recourse liabilities, which cause the entire loan to become fully recourse to the borrower and guarantors.

As a result of the COVID-19 pandemic, a new wave of commercial mortgage loan defaults is surely on the horizon. For owners whose commercial properties are encumbered by CMBS-type mortgages, there are concerns that, once again, some CMBS mortgage holders will seek to exert pressure against borrowers and their carveout guarantors by invoking certain carveouts. While we cannot anticipate all of the ways in which this is likely to happen, there are some springing-recourse carveout clauses that are soon likely to cause borrowers and guarantors significant grief.

One typical springing-recourse carveout provides for full recourse in the event a borrower admits its inability to pay its debts. Another is triggered if a borrower fails to obtain its lender's consent to any other "Indebtedness." For example, if a borrower obtains a loan under the Payroll Protection Program, such additional debt would breach the carveout against other debt.

An even more nefarious effort to impose full recourse liability could be framed around a landlord's desire to help a struggling tenant. This springing recourse carveout prohibits any transfer of the mortgaged property without the lender's consent.

We have already seen many tenants request rental concessions due to the current pandemic. Some are even withholding rental payments while they are prohibited from opening their businesses. It is entirely likely that some owners will amend leases without first obtaining their CMBS lender's consent, either by intentionally or accidentally overlooking provisions of the loan documents that may require a lender's consent. A CMBS lender could determine that such unapproved lease amendments are an impermissible transfer, thereby triggering full recourse liability under a CMBS loan.

If history teaches us anything, it is that the holders of CMBS loans will, upon a default in payment, exert every leverage to achieve the outcome that is best for them. CMBS borrowers are advised to carefully review their loan documents and consult with their legal counsel before making any significant decisions, as they evaluate the impact of the current pandemic.

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