Drafting and Securitizing Participation Mortgages: A Re-Introduction

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DRAFTING AND SECURITIZING PARTICIPATION MORTGAGES: A RE-INTRODUCTION

SPENCER J. COOPCHIK AND YILDIRAY YILDIRIM

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This Paper will reintroduce, explore, and expand on the financing arrangement known as a Participation Mortgage. First, this Paper will cover the features, history, and policy purposes behind the mortgage. Second, the Paper will focus on legal mechanics and drafting considerations of Participation Mortgages, so they may later be securitized. Finally, the Paper will explore the possibility and legality of creating Participation Mortgaged Backed Securities to be sold in the secondary market.

I. INTRODUCTION

In the most basic sense, a Participation Mortgage (PM) is an alternative “financial innovation where the lender accepts a below market interest rate in return for a contingent share in the cash flows from operations and/or appreciation of the property.” Essentially, the borrower receives a loan at a below market interest rate but makes additional interest payments contingent on the net operating income of the mortgaged property (SIM or Shared Income Mortgage) and/or additional payments based on a stated percentage of the appreciation in value of the mortgaged property (SAM or Shared Appreciation Mortgage) at the time of any stipulated “equity event.”

Therefore, the “overall return to the lender consists of two elements: (1) a fixed-rate interest return that usually is 50 to 200 basis points (0.5% to 2%) below comparable nonparticipating debt, and (2) a participation (known as a
‘kicker’ or ‘additional interest’) in the future growth of the property.”

There are four basic types of participations: (1) percentage of cash flow after debt service; (2) percentage of effective gross income; (3) percentage of appreciation of the property; and, (4) fixed fees. The PM used in this Paper will focus exclusively on mortgages containing the second or third types. However, rather than taking a portion of the gross income, a more equitable PM—like the one outlined here—will take a percentage of the net operating income (SIM).10

The additional interest arrangements in PMs are appropriately suited for commercial properties because the means of participation assumes the property generates income. The additional interest payments based on net operating income can be paid from income generated by rent or leasing arrangements set in place by the borrower. These profit sharing or SIM payments are paid quarterly. SAM works for either residential or commercial property. The appreciation value, if any, can be paid either annually or at maturity/sale based on qualified appraisals.

For the purposes of this Paper, we will focus on commercial properties with additional interest payments based on a percentage of the SIM or appreciation of the underlying property. The sample mortgage used throughout the Paper will be based on policy preference for ethical lending principles. It will have two “regular interests” payments; the first being fixed monthly principal payments and, the second, floating rate payments equal to LIBOR plus zero basis points. The participation provisions will consist of a single “residual interest,” a quarterly participation in the SIM or SAM.

In the United States, PMs developed during the high inflationary period of the 1970s.11 They became more popular in the mid-1980s when interest rates were high because they were viewed as viable alternatives to traditional fixed rate mortgages.12 However, with the advent of adjustable rate mortgages, PMs never became popular enough to have a role in the rise of the secondary mortgage backed securities market. Thus, the majority of the legal literature on

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9 Id.
10 SIM is the “income derived from operating a business, after subtracting operating costs.” BLACK’S LAW DICTIONARY 881 (10th ed. 2009). Thus, we have SIM and SAM.
PMs is over two decades old, and the PM needs to be reintroduced to the real estate finance community. Fortunately, “equity kickers” and shared appreciation mortgages are often used in workouts in properties recovering from the financial crisis or mezzanine loans. Therefore, the use of PMs in commercial loans needs to be reintroduced to facilitate lending based on shared risk and shared profit.

Lenders are attracted to PMs because they provide a “hedge” against inflation, especially in connection with a longer-term mortgage. More importantly, PMs can provide higher yields and may be less risky in a workout transaction.\(^{13}\) Likewise, PMs also have a number of advantages that make them attractive to the borrower including: less overall economic risk; hedging against high interest rates during periods of significant inflation; the additional or “contingent” interest payments are fully tax deductible; the ability to retain full ownership and control of the mortgaged property up to the maturity date; and possibly eliminating the need to obtain separate equity financing.\(^{14}\)

Currently, there is no evidence suggesting such alternative mortgages have ever been pooled and securitized. This may be because regulations controlling Real Estate Mortgage Investment Conduits (REMIC) and Real Estate Investment Trusts (REIT) prohibit issuing or holding particular types of interests.\(^{15}\) Such regulations are illogical because REITs are fully capable of holding equity interests and REMICs can issue residual interests, which may be based on far riskier returns than appreciation or income payments. Why PMs are singled out in these regulations is unknown; however, the rules should be reevaluated to promote PMs as well as more ethical lending practices.

PMs have the potential of fixing many of the ills that led to the financial crisis. They are more equitable and less risky for the borrower because a borrower who is less profitable, or unprofitable, makes little or no payment and does not have to worry about defaulting on a high fixed rate of interest. Because profit sharing is the centerpiece of a PM, banks are forced to make more educated loans based on an in-depth inquiry into the business savvy of the borrower. However, for the extra risk, PM loans have the potential to bring in higher yields than the average fixed rate mortgage.\(^{16}\) To promote the use of PMs, they must be reintroduced with a framework that will facilitate their securitization in the secondary mortgage market, which was not the case when PMs were first used in the 1980s. It is the Authors’ aim to reintroduce PMs to


\(^{14}\) Barach, supra note 13, at 117.

\(^{15}\) See infra Part III.

\(^{16}\) Id.
today’s mortgage market and create securities based on the participating arrangements.

II. DRAFTING CONSIDERATIONS AND LEGAL ISSUES REGARDING THE MORTGAGE

There are a number of legal issues involved that affect the validity, enforceability, transferability, and securitized value of PMs. Therefore, careful drafting considerations should be made to prevent unnecessary challenges from arising when the mortgage is later securitized. “The foundation of all mortgage backed securities are the mortgages themselves.” 17 If the documentation is defective, it will not support the security. 18 Because the focus of this Paper is the ultimate securitization of PMs, only a few legal issues will be addressed, along with accompanying drafting considerations and solutions. These legal issues include: use of one or two mortgages, inclusion of the participation provisions, recharacterization as a joint venture/partnership, usury, clogging of equity redemption, defeasance, and default. 19

A. Use of One or Two Mortgages

Before we consider issues relating to the completed mortgage instrument itself, it is important to address whether the property is secured by one or two mortgages—whether the fixed interest and contingent interests should be drafted and secured as separate mortgages. Generally, the contingent interest provisions are “embodied in a separate, unrecorded ‘contingent interest agreement’ . . . [to] enable the lender to subsequently characterize the contingent interest feature as a separate transaction so that its invalidation will not impair enforcement of the underlying note and security documents.” 20 However, some lenders go one step further and create a second mortgage for the contingent interest provisions. 21

Of the literature on the subject, some favor the use of two mortgages. Using two mortgages may help determine the amounts due at refinancing and

18 Id.
19 John C. Murray, Participating Mortgage Defaults—Analysis of Certain Legal Risks, C516 ALI-ABA 577, 579 (1990); see Murray, supra note 7, at 477; Barach, supra note 13, at 117; Kiefer, supra note 11. These sources suggest title insurance against the issues mentioned.
20 Kiefer, supra note 11, at 219.
21 Id.
defeasance, and the amount to bid at a foreclosure sale. If this approach is taken, the contingent interest mortgage should have priority so the lender may foreclose on the fixed interest mortgage without “wiping out the borrower’s contingent interest obligations.” Finally, it is argued that the use of two mortgages makes the sale and securitization of PMs easier because selling the fixed rate mortgages separately is more attractive to investors. There is some validity to this argument, not because it is more attractive to investors, but rather because regulations hinder the securitization of mortgages with contingent interest features like SIMs and SAMs.

Regulations of REMICs permit the REMIC to issue either regular or multiple classes of interests and only a single class of residual interests. Unfortunately, contingent interest features are categorized as residual interests when they should be deemed a permissible variable rate under regular interests. Because the REMIC can only issue one class of residual interests, the SIM and SAM are usually excluded from mortgage pools. Also to blame is a regulation prohibiting REITs from holding mortgages, or a pool of mortgages, with contingent interest features. Both of these regulations should be reconsidered to allow PMs that meet the principal interest requirements to be both issued as regular interests and held as such in REITs. In spite of the well-intentioned but over-inclusive regulations, the purpose of this Paper is to facilitate the securitization and sale of Participation Mortgage Backed Securities (PMBS). It would be wise to draft and sell both contingent and floating interest features together in a single instrument. Furthermore, these interests can be “stripped” before pooling if needed. Therefore, the use of two mortgages is not necessary. Of course, this would entail the addition of securitization

22 Murray, Participating Mortgage Defaults: Analysis of Certain Legal Risks, supra note 19, at 602.
23 Kiefer, supra note 11, at n. 1.
24 Ideally, a PMBS would contain three interest features: the floating rate, the shared appreciation (SAM), and a portion of the net operating income (SIM). But, because of regulations discussed throughout this Paper, such a task is currently impracticable. Either way, the PMBS in theory should be more attractive to investors than the standard CMBS because there is a possibility of a greater yield from the participation interests, in addition to the more stable floating interest and principal returns.
26 See Real Estate Mortgage Investment Conduits, 57 Fed. Reg. 61293-01 (Dec. 24, 1992) (to be codified at 26 CFR pt. 301 & 602) (“[C]ertain obligations that contain contingent payment provisions can be stripped of the contingent payment rights and the holder of those rights will not be considered to hold an interest in the REMIC. Thus, for example, if a loan not only has a fixed principal amount and provides for interest at a fixed rate, but also contains a shared appreciation provision, the holder of the loan can contribute the fixed payment rights to a REMIC and retain the shared appreciation rights, and those retained rights will not be considered to be an interest in the REMIC. Of course, the owner could have contributed the entire loan to the REMIC and taken back
provisions in the mortgage.

B. Inclusion of Participation Provisions

The participation provisions are what make the mortgage a PM and what will ultimately make the securitized loan a PMBS. The PM will have one participation provision, either for the shared appreciation in the property or for the shared percentage of net operating income. For reasons discussed in the next section, these terms should be properly characterized as additional interest and not shared equity.

Before addressing the participation provisions, it should be noted, in drafting a PM, there must be no risk to the principal. This means payment of the principal is unaffected by the contingent interest provisions and must be paid back in full whether or not the property is profitable or appreciates. Failure to meet this standard will prohibit the lender from making the loan and inhibit a REMIC from later securitizing it. However, once this condition is met, the participation provisions may be included.

First, we must address the shared appreciation provision. There are two ways the additional interest in shared appreciation can be collected. The first is upon maturity, or early discharge of the loan by sale of the underlying property. The second would be based upon quarterly or annual appraisals that determine the appreciation of the underlying property. In both cases, an appraisal is required to determine the value of the property. Therefore, explicit and detailed provisions regarding the appraisal process should be included and agreed to. The lender, or future mortgage holder, will want to use its appraiser, the borrower may want a second appraisal, and a third

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27 Bank’s Role in Transaction was That of Lender in a Shared Appreciation Mortgage and not General Partner or Participant in a Joint Venture, Fed. Banking L. Rep. ¶ 83,502 (CCH), 1992 WL 12610329, (July 15, 1992) (“A national bank’s authority to employ participatory financing arrangements is subject to certain limitations . . . to ensure that the bank’s role in providing such financing is that traditionally assumed as a lender. There must be no risk to loan principal other than that arising from a borrower’s default; in this regard, Interpretative Ruling 7.7312 requires that the repayment of principal shall not be conditioned upon the profit, income or earnings of the business enterprise. Further, in keeping with the provisions of 12 U.S.C. §§ 24(7) and 29, a national bank can have no possessory or ownership interest in a borrower’s business or real estate.”) (internal citations omitted).

28 See Kiefer, supra note 11, at 228–29.
29 Id.
30 Id.
31 See id.
32 Id.
“neutral” arbitrator may be used. \(^{33}\) Such expenses should be drafted so the borrower pays part or all of the appraisal costs. Additionally, the rights the lender has in regards to appraisal must be transferable to future mortgage holders; as such, the agreement should include a provision notifying the borrower that a future mortgage holder or loan servicer may seek the annual appraisal to calculate its participation rate. The appraisal provisions should keep in mind interim, pooling, and servicing agreements that will appear later in the securitization process.

It should be noted a PM containing a SAM provision will also have a maintenance provision. This provision creates an account whereby the borrower will deposit money to maintain the property so the property does not depreciate in value due to the deliberate act, negligence, or general lack of care by the owner or tenant. The maintenance provision should grant the lender or subsequent servicer the authority to force the borrower to use the funds in the account to repair or improve the property if needed.

The provision that entitles the lender to a participation percentage of the net operating income is more complicated. It should contain five parts. The first should grant the lender a payment of additional interest out of a percentage of the quarterly net operating income. The following provision is suggested:

In addition to the interest provided under Section [number of section] of this instrument, the Mortgagor hereby agrees to pay to the Mortgagee additional interest in quarterly installments on or before the last day of the month following the end of each calendar quarter, commencing [date of commencement] for the calendar quarter ending [end date of quarter]. Such additional interest shall be an amount equal [percentage rate of additional interest] of the [net operating income], as defined in Section [number of section] herein, from the operation of the Premises. Each quarterly installment shall be based upon the [net operating] from the operation of the Premises for the preceding calendar quarter. \(^{34}\)

A following or preceding section should define net operating income and include a description of expenses that can be deducted from the total income in calculating the net operation income. A third provision should call for the borrower to send financial statements evidencing operating income and expenses with the payments of additional interest. A fourth provision should allow the lender, its agent/servicer, a later mortgage holder, or their agent/servicer to examine the financial records and request an audit if needed. Finally, there should be a provision that entitles the borrower to collect any

\(^{33}\) Id.

\(^{34}\) ARNOLD, supra note 8, § 7.1.
additional funds it discovers were due, if an audit of the borrower’s financial records reveals additional funds should have been paid.

It is important to keep in mind both participation provisions require some involvement of a third party in the appraisal or audit and may complicate securitization, as these rights of inspection and appraisal need to be transferred as well, particularly in the pooling and servicing agreement. The provisions in the mortgage should inform the borrower that it may send financial statements and appraisals to a loan servicer in the future. Such provisions should be similar to those in the defeasance section. Summarily, the participation provisions must be drafted in a way to facilitate trading such that loans may continue to be serviced after the underlying mortgage is sold and securitized.

C. Recharacterization as a Joint Venture or Partnership

A PM is not, and cannot be, a joint venture or a partnership. Possibly the most important consideration when drafting a PM is to avoid the appearance and recharacterization of the mortgagor-mortgagee relationship into a joint venture or partnership. Recharacterization would likely preclude securitization, have negative tax consequences, inhibit foreclosure remedies, force a loss of lien priority, and create shared liability for debts and civil damages, among other problems. The focus of this discussion is the recharacterization issues regarding securitization and default.

First, the establishment of a joint venture or partnership through the PM would preclude latter securitization of the mortgages. Case law across the states indicates interests in a general partnership, joint venture, or limited partnership are usually not considered securities and cannot be traded in the secondary market. Therefore, to promote the securitization of PMs, the mortgage needs to be structured soundly, as improper drafting could lead to the formation of a joint venture or partnership, making the creation of PMBS impracticable.

Careful consideration of the elements of a partnership or joint venture is important when drafting the loan and during the continuation of the relationship between mortgagor and mortgagee. Under the 1914 Uniform Partnership Act (UPA), a partnership is defined as “an association of two or more persons to carry on as co-owners a business for profit . . . .” Under this

35 See Kiefer, supra note 11 (providing a full list of other legal issues involved in the finding of a joint venture or partnership).
36 George G. Yearsich, Securities Law Aspects of Partnerships, LLCs, and LLPs, SM074 ALI-ABA 1129, 1157 (2007).
37 UNIF. P’SHP ACT § 6 (1914).
definition, the courts used a four-factor test to determine whether a partnership exists. The courts looked at “(1) the parties’ intent to form a partnership, (2) the sharing of profits, (3) the sharing of losses, and (4) the relative control of the parties over the affairs of the enterprise.” Therefore, in states that still adhere to this version of the UPA, elements like intent and control should be contracted out of the loan agreement. However, the fourth element requires the lender to modify its behavior to limit the appearance of control over the borrower’s activities and, thus, over the formation of the partnership or joint venture.

Currently, under the 1997 UPA, adopted in most states, a partnership is the “association of two or more persons to carry on as co-owners of a business for profit forms a partnership, whether or not the persons intend to form a partnership.” The italicized clause may allow a debtor in a foreclosure proceeding to claim partnership by estoppel, thereby raising additional issues surrounding default and inhibiting foreclosure. Courts have not been persuaded by this argument. Fortunately, the criteria in the 1997 UPA for determining whether a partnership exists leaves ample room for the formation of PMs and should preclude the debtor from raising such a defense. The UPA states:

In determining whether a partnership is formed, the following rules apply:

(1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property. (2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived. (3) [But, a] person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment: (i) of a debt by installments or otherwise: . . . (iii) of rent: . . . (v) of interest or other charge on a loan, even if the amount of payment varies with the profits of the business . . . .

The Comment explains:

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41 UNIF. P’SHP ACT § 202 (1997).
42 UNIF. P’SHP ACT § 202 (1997) (commenting the quote within the quoted passage above is taken from Section 211 of the Uniform Land Security Interest Act).
Paragraph (3)(v) adds a new protected category to the list. It shields from the presumption a share of the profits received in payment of interest or other charges on a loan, including:

- a direct or indirect present or future ownership in the collateral, or rights to income, proceeds, or increase in value derived from the collateral . . . . The purpose of the new language is to protect shared-appreciation mortgages, contingent or other variable or performance-related mortgages, and other equity participation arrangements by clarifying that contingent payments do not presumptively convert lending arrangements into partnerships.\(^43\)

Conclusively, the SIM and SAM provisions of PMs should not be subject to the presumption of a joint venture or partnership arising under UPA § 202(3).

Nonetheless, if a court finds that a joint venture or partnership exists, it would limit the lenders ability to bring foreclosure proceedings because it would be inconsistent with legal rights and duties of a partner or co-venturer to bring default against its partner or co-venturer.\(^44\) Therefore, the drafting lender must eliminate the appearance of intent to form a joint venture or partnership from the loan documents.

Thus, to avoid recharacterization and the finding of a joint venture or partnership, the loan documents should include provisions that: (1) address the elements of partnership (intent, profit/loss sharing and control), (2) define and maintain that the payments from shared income and appreciation are payments of additional interest and not shared equity, and (3) make reference to the provisions and distinctions set forth in UPA § 202(3)(v) that remove the presumption of the formation of a joint venture or partnership.

A provision that defines the relationship as that solely between a mortgagor-mortgagee must be included. The following language is suggested:

The relationship of the parties is strictly that of mortgagor-mortgagee; that the participating rights granted to the mortgagee with respect to profit from operations of, appreciation in the value of, or profit from any sale or any further financing or encumbrance of the real property [are those described in § 202(3)(v) of the 1997 Uniform Partnership Act and] do not under any circumstances constitute the acquisition of an equity interest in the mortgaged property by the mortgagee or constitute a partnership, joint venture, or tenancy in common between the parties; that the only relationship between the parties shall be that of mortgagor and mortgagee; and that the mortgagor agrees to defend and indemnify the mortgagee against any claim or characterization to

\(^{43}\) Id.

\(^{44}\) Kiefer, supra note 11, at 225.
Furthermore, any definition section should ensure the participation provisions and terms are creating payments of additional interest, not equity. In addition, there must be a clause addressing the control element of a joint venture or partnership. Such a clause would include a statement that grants the borrower free use of the mortgaged property. Finally, any clauses providing for added control, aside from those needed to acquire the participation percentage of the net operating income, that are not customarily given to a lender should be excluded or removed.

D. Usury

Contingent interest payments under the SIM and SAM provisions should not be considered usurious because they are not definite. Generally, “the mere possibility that the loan provides for contingent interest that exceeds the legal limit does not automatically render the loan usurious.” Because the interest payments are contingent on market factors, the amount paid under the participation provisions may vary from quarter to quarter and year to year. Even if the rates were aggregated, usury should be determined from the amount to be paid and not the stated combined interest rates.

However, lenders should still consider usury issues because the SIM and SAM provisions are considered additional “interest.” This is because the amount of contingent interest, when added to the fixed or floating rate, may exceed state usury limitations. This would occur if the secured property significantly appreciates in value or the commercial use is exceedingly profitable during the loan’s term.

Normally, usury is a state law issue. States have varying ways of

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45 Murray, supra note 7, at 485.
46 Id.
47 “Furthermore, . . . to be considered usurious, a loan must be ‘absolutely, not contingently, repayable.’ Payments that are not known to the lender or ascertainable by reasonable inquiry at the time of making the loan are excluded from the operation of the usury statute. At the time the parties contracted, it was impossible to predict future market conditions and what positive appreciation of the [p]roperty, if any, would materialize. Thus, the contingency of realized appreciation of the [p]roperty places the parties’ agreement without the scope of G.L.C. 271, § 49.” Comstock v. Steinbergh, No. 20042093J, 2004 WL 3120554, at *4 (Mass. Super. Dec. 16, 2004) (citations omitted).
50 Id.
approaching usury. The maximum rates differ among the states as well as exceptions and means of circumventing the limitations on interest. However, characterizing the interest as an “equity participation” as a means of circumventing usury limitations should absolutely be avoided. It could lead to the problems of recharacterization discussed in the previous section.

The penalties for charging usurious interest range from elimination of the interest, to elimination of the principal, and even criminal charges. Some states provide exceptions “where the loan is secured by a mortgage or where the borrower is a corporation, or if the loan funds are to be used for a business purpose, or the loan is in excess of a certain amount.” A few jurisdictions even provide statutory or common law exceptions or both statutory and common law exceptions for contingent interest features in mortgages.

There are three methods recommended for avoiding the finding that a loan is usurious. The first method is a choice of law provision that chooses a jurisdiction that exempts contingent interests or has no usury rate. However, this must been done in good faith and the state chosen must have some relation to the transaction, not merely to avoid usury rates. The second method is for the mortgage to contain a clause providing that in “the event the total interest paid exceeds the appropriate usury level, then the portion of the interest in excess of the usury level is to be applied in reduction of principal indebtedness.”

Other resources suggests a third method by including a “savings clause” stating:

[I]f the aggregate rate of interest payable under the note shall at any time be deemed to exceed the applicable usury ceiling, the note shall instead bear interest at the applicable ceiling until such time as the amount of interest that would otherwise accrue under the note equals the amount permitted by the applicable ceiling, with the difference between these two amounts accruing and being payable either when the otherwise applicable interest rate drops below the applicable ceiling or, to the extent not sooner paid, at maturity.

For the purposes of promoting PMBS, the savings clause may be preferable, as it would provide more favorable returns to the lender and

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51 Id.
52 ARNOLD, supra note 8, at § 7:10.
54 ARNOLD, supra note 8, at § 7:10.
55 Kiefer, supra note 11, at 221.
56 Id.
subsequent investors in PMBS.

E. Clogging of Equity Redemption

Clogging is a common law doctrine holding there can be no provision, aside from foreclosure or default provisions, that prevents the mortgagor from ultimately retaining the property after paying off the loan, or that gives the lender a “collateral advantage.” The fear of clogging as it relates to PMs was overblown by commentators on the advent of SAMs and PMs. However, nearly thirty years later, we have found no cases where clogging was raised as a valid defense.

Clogging should not arise in connection with PMs because the mortgagor is not prevented from redeeming the mortgaged property or paying off the loan. However, the clogging issue may be raised when negative amortization occurs, or when the mortgagee is allowed to continue to collect contingent interest after payment of the underlying debt. Therefore, the mortgagee should provide that all contingent-interest and shared-appreciation are not capitalized into principal during the term of the loan. If the mortgagee “elects to refinance the loan at maturity, separate consideration will have been established at such time to support capitalizing the contingent-interest payments and adding them to the principal balance of the new loan.”

“Clogging” would most likely occur where a contingent-interest survives payment of the underlying mortgage debt. Therefore, the lender should not retain the right to receive contingent interest payments after the maturity date of the underlying mortgage loan. Additionally, in a foreclosure proceeding a mortgagor may seek a dismissal claiming the contingent interest or shared appreciation mortgage in the PM is not a mortgage, but rather an equity interest in the mortgaged property. To avoid such a claim, the PM should clearly establish the parties’ intention that the participation interests are not equity interest in the mortgaged property as discussed in the recharacterization section.

57 Murray, Participating Mortgage Defaults-Analysis of Certain Legal Risks, supra note 19, at 584; John C. Murray, Clogging Revisited, 33 REAL PROP. PROB. & TR. J. 279, 300 (1998).
58 Murray, Recharacterization Issues in Participating and “Equity Kicker” Mortgages, supra note 7, at 508.
59 Murray, Participating Mortgage Defaults-Analysis of Certain Legal Risks, supra note 19, at 584.
60 Id. at 580.
61 Murray, Clogging Revisited, supra note 57, at 300.
F. Defeasance

For PMs to be marketable, they must have a means of preventing and handling prepayment. Therefore, a PM should include a prepayment disincentive. Because a REMIC will be used as the SPV, or where the underlying property is commercial, defeasance should be used. For a number of reasons, defeasance is preferable.

First, defeasance is an equitable resolution for the mortgagor and future investors in PMBS. It is:

\[\text{A process whereby a borrower substitutes collateral for the real estate subject to a lender’s lien to enable the lender to maintain the same level of interest payments it would have obtained had the borrower continued to make payments according to the loan agreement. The substituted collateral typically consists of Treasury securities.}\]

The lender:

\[\text{Accepts the Treasury obligations as substitute security and releases its lien on the mortgaged property. All investors in the securitized pool continue receiving their payments on schedule, including purchasers of interest-only strips. The cash keeps flowing but from U.S. Treasury obligations, not a mortgage, increasing the value of the investment by the amount by which investors prefer government bonds to mortgages.}\]

A second, and perhaps more important, reason defeasance should be used, rather than another prepayment disincentive, is because it facilitates the securitization of the mortgage. As will be discussed later, to securitize PMs, a REMIC will be used as the special purpose entity or vehicle (SPV). REMICs can only hold ”qualified obligations.” If prepayment occurs in a securitized commercial mortgage, then CMBS can only be modified or replaced by a qualified substitute. Under federal regulation, only ”substitute collateral that consists solely of government securities” would qualify for REMIC status. Thus, it is implied in the regulations that defeasance with treasury bonds should be used in the PM.

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64 Varli & Yildirim, *supra* note 12.
Additionally, the use of REMIC requires that any defeasance in an underlying mortgage cannot occur until two years after the start up. Therefore, in addition to a defeasance clause, a two-year “lock out” clause is required in a PM, so it may be considered a qualified obligation, held by a REMIC, and ultimately securitized.

G. Default

Under the terms of the PM outlined in this Paper, default would occur at the non-payment of the principal, floating interest rate, as well as SIM and SAM rates. For the purposes of a PM, the default provisions regarding the principal should be similar to those in traditional commercial mortgages. The goal of the default provision is to get the borrower paying or “performing” again. Like other mortgages, there should be provisions allowing for grace periods and giving the borrower the right to cure default and perhaps pay penalties. However, “Default Interest” penalties should not increase the floating rate of interest, but rather decrease it and extend the term of the loan.67

Default under the SIM provisions occurs under three scenarios.68 The first scenario would be one in which there is a net operating income sufficient to pay the SIM rate, but, for whatever reason, the borrower does not pay.69 Such non-payment would result in a temporary increase of the SIM rate as a penalty.70 The second scenario would be where the borrower does not generate enough net operating income to pay the SIM rate.71 Here, the lender would decrease the SIM rate and lower the quarterly payments but increase the term of the loan, thereby increasing the overall profit earned on the SIM rate.72 The final scenario would be where no income is generated; here, the lender or subsequent servicer could force foreclosure if needed.73

Default resulting from non-payment of the SAM rate would only occur where the property appreciates in value, but, for whatever reason, the borrower fails to pay. Here, there can be a penalty by temporarily increasing the SAM rate.74 If, however, the property does not appreciate in value, the borrower is not required to make any SAM payments. This is the risk born by the lender.

67 Varli & Yıldırım, supra note 12.
68 Id.
69 Id.
70 Id.
71 Id.
72 Id.
73 Id.
74 Id.
III. SECURITIZATION OF PARTICIPATION MORTGAGES

A. Can PMs be Securitized?

For PMs to be successfully reintroduced and adopted, it would be beneficial if they had the ability to be securitized. Before approaching the broader issue of how to securitize a PM, the first question that must be addressed is whether PMs can be securitized. Fortunately, there is no explicit reason why a PM could not be securitized. Like any other mortgage, if the PM is drafted properly and the correct steps were followed in the securitization process, it can be securitized. However, because of the SIM and SAM provisions, the process is slightly more complicated.

The Authors have not found any regulatory reason why commercial mortgages with the contingent interest participation features cannot be securitized. In fact, regulations regarding REMICs, the special purpose entities that will be used in the securitization process, imply securitization of contingent interest features is possible as long as the regulations regarding payment of the principal and the type of interests issued in the REMIC are followed. However, these same regulations also hinder the sale of PMs with more than one contingent interest feature. This is because the REMIC can only issue one residual interest, and SIM and SAM are considered residual interests. Therefore, a REMIC can only hold a PM with a SIM or SAM but not both. It is possible, however, to securitize a PM that contains two contingent interests by either stripping the SAM or SAM provision before entering into the REMIC or using a “taxable mortgage pool.”

As will be discussed below, the unique nature of the PM should only slightly modify the way in which the mortgage is securitized, particularly in terms of representations, warranties, the rights and duties of the loan servicers, and disclosure in offering documents. However, the general steps of the securitization process will remain similar to those creating ordinary MBS.

B. The Securitization Process

This section will briefly cover the securitization process and legal issues to consider when securitizing the PMs outlined above. After the transfer of the

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75 This will be discussed in detail within Part III. 26 C.F.R. § 1.860G-2(a)(7) requires that the PMs “provide[] for total noncontingent principal payments that at least equal the instrument’s issue price even if that instrument also provides for contingent payments.” 26 C.F.R. § 1.860G-2(a)(7) (2011).

mortgage and loan documents from the borrower to the lender, as detailed in the previous section, the securitization process generally consists of four stages.

The lender sells the mortgages to a purchaser, often called a “sponsor” or “originator,” under a Mortgage Loan Purchase Agreement (MLPA) and an Interim Servicing Agreement (ISA). The sponsor then sells the loans to a bankruptcy remote entity called a depositor under a second MLPA for the purposes of depositing loans into a securitization trust. Then, the depositor deposits the loans via a “true sale” into a Trust for Loan Pool, here a REMIC, pursuant to a Pooling and Servicing Agreement (PSA), under which the loans are pooled and classed according to risk.

Finally interests in the REMIC, and, thus, the underlying PM, are offered as “certificates,” or securities, after the seller provides proper disclosure in the offering and registration documents.

In the following subsections, the above stages will be covered with a focus on the corresponding transactional documents and legal issues that may arise during each stage of the securitization process as a result of the participation provisions in the PM. Essentially, there are three general types of documents in the process: purchasing agreements, pooling and servicing agreements, and offering documents.

It should be noted from the outset that in each of these documents, representations, warranties, and disclosure are key. While the overarching policy of PMs is more equitable lending, the prevention of another mortgage-based financial crisis will depend on greater disclosure and transparency. As such, special attention should be given to the disclosure requirements as they relate to the unique features of PMBS.

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78 The provisions of the ISA may be included in the first MLPA. Talcott J. Franklin & Thomas F. Nealon, Mortgage and Asset Backed Securities Litigation Handbook §2:10 (2d ed. 2011).
79 Id.
80 Id.
81 Fagan & Frankel, supra note 77; Franklin & Nealon, supra note 78.
82 Fagan & Frankel, supra note 77; Franklin & Nealon, supra note 78.
The Lender Sells the PMs to a Sponsor/Originator Pursuant to an MLPA and ISA

First, the mortgagee will sell the PM to a purchaser, likely an investment bank or an affiliate of an investment bank, often known as a sponsor or originator. This stage will contain two agreements—the MLPA and the ISA. The two may be combined into one document, thus both the sale and servicing provisions may be contained in the MLPA.

In the most basic sense, the MLPA is a conveyance of the ownership interests in the mortgages. The MLPA contains a number of representations and warranties regarding the duties of the seller, the underlying mortgages, their sale, and ultimate securitization. It also includes a series of covenants between the seller and the purchaser. Other key provisions in this MLPA include indemnifications, events of default, and termination. However, because the originator is often the lender, this stage may be skipped; therefore, the next section will focus on the details of MLPA provisions.

Whether included in the MLPA or not, the ISA provides for servicing of the loan before the closing. Under this MLPA, it is typical that the seller or its agent will continue to service the loan prior to closing and before the originator re-sells it to a depositor. This may be better for PMs because the lender already has a working knowledge of the business activities on the property and the ongoing relationship that facilitates collections under the participation provisions.

Sponsor/Originator then Sells the Loans to the Depositor under a MLPA for the Purposes of Depositing Loans into a Securitization Trust.

Next, the originator sells the mortgages to the depositor, a bankruptcy remote entity, pursuant to another MLPA. Like the first MLPA, the focus is

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83 FRANKLIN & NEALON, supra note 78.
84 Id.
85 Id.
86 Id. §§ 1:73, 1:74.
87 Id.
88 Id.
89 Id.
90 Id. §2:10.
91 Id.
92 Id.
the conveyance of mortgages. However, here, the depositor only holds the mortgages momentarily before depositing them into the SPV. Therefore, the representations, warranties, and remedies for breach made by the originator in this MLPA are critical for later offering documents.

Unlike the first MLPA between lender and originator, initially this MLPA notes the depositor in this transaction will convey these mortgages to an already existing trust pursuant to a separate PSA. The key provisions of an MLPA at this stage include: (1) the conveyance of mortgage loans; (2) examination of the mortgages and due diligence review; (3) representations, warranties, and covenants, some of which may be the same or similar to the previous MLPA; (4) remedies upon breach; and (5) closing documents. These provisions are typically guided by the regulations on REMICs and provisions of the PSA.

First is the agreement to convey the mortgages and the rights therein. However, because the mortgage loans are immediately deposited into the Trust for Loan Pool (in a REMIC or trust) following the conveyance of the mortgage loans from the originator to the depositor, the originator receives as consideration a portion of the proceeds from the securities issued by the trust. Additionally, the seller agrees to provide the depositor, servicer, and trustee with the file for each mortgage.

Normally, each file includes the mortgage loan, the note, title insurance, assignments, ground leases, information about tenants, and other documents relating to the underlying property, as well as financial records about the seller. For the purposes of PMBS, these files should also include the documents relevant to the participation provisions of the PM. Particularly, quarterly financial records, annual appraisals, related and payments made under those provisions, if any, and a summary of such records and payments prepared by the interim servicer. Additionally, such recordings should be included in the servicing file sent to the master servicer.

Unlike the first MLPA, representations made by the seller will be assigned by the depositor to the trust in the form of the prospectus and other offering documents, and, thus, the seller will also agree to indemnify the depositor and issuer either in the MLPA or in a separate indemnification
Therefore, the parties to the PSA can have recourse against the seller, including the right to remedy misrepresentations made in the MLPA, particularly in regards to “defective obligations.” For the purposes of PMBS, the depositor might want to include additional covenants regarding SIMs and SAMs, such as provisions in which the seller makes a promise to provide due diligence reports, auditing records, and appraisals surrounding the commercial property and the business activities thereon.

If any of the representations, warranties, or covenants are not met, the seller may be in breach. Subject to the proper notice provided by the trustee, if material breach occurs relating to the conveyance and the underlying mortgage documents,\textsuperscript{100} the originator has the right to cure within a specified time, usually ninety days pursuant to REMIC regulations, through a correction, replacement (substitution), or repurchasing.\textsuperscript{101} If the breach is a result of a defective document, it can be cured if the originator makes the required correction in a given time frame. If it is repurchased, the originator buys the mortgage back from the trust at a price generally equal to the loan balance plus accrued interest. For the purpose of PM repurchases, the repurchase would include the payments due, if any, under the SIM and SAM participation provisions.

The greater concern for breach occurs if an underlying mortgage is or becomes a “defective obligation.”\textsuperscript{102} This means the mortgage is in default, or it is “reasonably foreseeable” it will enter into default, or was fraudulently

\textsuperscript{99} Typical representations, warrants, and covenants include: (i) the information in the mortgage loan schedule is correct and complete in all material respects; (ii) the mortgage loan seller has good title to mortgage loans and is transferring them free and clear of liens and other encumbrances; (iii) the applicable mortgage is a valid and enforceable first priority lien on the related mortgaged property; (iv) the loan documents have not been modified; (v) there has been no holdback or advancement of funds (other than the mortgage loan); (vi) certain ground lease representations, if applicable; (vii) there is no mezzanine debt (either currently outstanding or permitted to be funded in the future); (viii) there is no material litigation affecting the value of the related mortgaged property or borrower/guarantor’s ability to make payments under the mortgage loan; (ix) there is no cross-collateralization with another mortgage loan that is not being transferred to the trust; (x) any release and partial release provisions satisfy certain standard criteria; (xi) any permitted defeasance provision satisfies standard criteria (including that defeasance is not permitted until two years after securitization date); (xii) each mortgage loan contains a standard due-on-sale clause; and (xiii) mortgage loans over a certain amount comply with single purpose entity (SPE) requirements. In the event that a representation is untrue with respect to a particular mortgage loan, the mortgage loan seller will disclose that as an exception to the representation. Id.

\textsuperscript{100} Save for agreed-upon exceptions that may be made for individual mortgages, such exceptions to the general representations and warranties are often included in MLPAs.


procured by the borrower, or the “mortgage does not conform to a customary representation or warranty given by the sponsor or prior owner of the mortgage regarding the characteristics of the mortgage, or the characteristics of the pool of mortgages of which the mortgage is a part.”

Fortunately, the “defective obligation” can be replaced or repurchased subject to the rules in 26 C.F.R. § 1.860G-2. If the defective obligation is replaced by another PM, that PM must be a “qualified obligation.” For a PM to be a “qualified obligation” under the Federal Regulations regarding REMICs, principal payments must be paid according to 26 C.F.R. § 1.860G-2(a)(7), which requires that the PM “provides for total non-contingent principal payments that at least equal the instrument’s issue price even if that instrument also provides for contingent payments.” Additionally, REMIC regulations require that such a replacement occurs within two years of closing the transaction. Finally, the seller may agree that any replacement shall be completed according to the terms of the PSA. This may include payment of the substitution shortfall amount equal to the excess, if any, of the purchase price for the mortgage loan to be replaced over the principal balance of the replacement loan together with any additional amounts specified in the PSA.

The final section of the MLPA deals with the closing and related closing documents. The provisions in these sections “set forth the conditions precedent for the closing of the sale of the mortgage loans. These provisions will describe the various officer’s certificates, opinions, due diligence materials[,] and other items that must be completed and reviewed by each party prior to the closing of the sale.” As long as sufficient disclosure is made regarding the nature and risk involved in the underlying PMs, there is no reason the closing should be any different than another transaction of commercial mortgages.

iii. Then, the Depositor Deposits the Loans into a Trust or Loan Pool Pursuant to a Pooling and Servicing Agreement (PSA)

After purchasing the mortgage loans from an originator, the depositor holds them only momentarily, before depositing them in a Trust for Loan Pool.
This transfer is done pursuant to a PSA. The key parties to a PSA are the depositor, the master servicer, the special servicer, the trustee, trust advisor, the certificate administrator, custodian, and tax advisor.\footnote{Trust advisor, tax advisor, and custodian may all be one entity. The trustee may also play the role of custodian.}

There are two overarching agreements in the PSA: the pooling agreement and the servicing agreement. The first relates to pooling of the mortgages, providing for the subsequent issuance of the certificates and payments structures thereon. The second relates to the collection of payments due from the borrowers in the underlying mortgages by servicers so that cash flow may be distributed through the trust and to investors.

\textbf{a. Pooling}

The first provisions of the PSA create the trust fund to which the mortgage loans will be conveyed. Additionally, the trustee, typically a national bank, is named. The trustee is the representative of the certificate holders and forwards the payments of principal and interest, as well as other relevant investment information to them.\footnote{FRANKLIN & NEALON, \textit{supra} note 78, § 1:67.}

The mortgage loans and accompanying files are then accepted by the trustee subject to the representations, warranties, and covenants made by the depositor, which are similar to the ones made by the seller in the MLPA.

The trustee then conveys the loans to the REMIC, which is established in and during the creation of the trust by the PSA. This is because a REMIC may be formed as any type of entity or simply “as a segregated pool of assets.”\footnote{26 C.F.R. § 1.860D-1 (2011).}

The structure of the REMIC pools can either be single-tiered or multiple-tiered. The certificates issued from a single tier represent beneficial ownership interests in a single REMIC pool within the related trust fund.

A multiple-tiered REMIC structure is when the PSA creates a two-tier REMIC structure consisting of an upper-tier REMIC and lower-tier REMIC.\footnote{Patrick D. Dolan, \textit{Lender’s Guide to the Securitization of Commercial Mortgage Loans}, 115 BANKING L.J. 597, 598 (1998) (“A few transactions have been structured as triple-tier REMICs to further insulate holders of the regular interests in the upper-tier REMIC from changes in the underlying mortgage loan pool. The third-tier REMIC holds the regular interests in an intermediate second-tier REMIC, which in turn holds the regular interests in a first-tier REMIC. The [o]riginator or an affiliate of the [o]riginator generally will hold the residual certificate.”).}

The lower-tier REMIC acquires a pool of real estate mortgages and issues a residual interest and classes of regular interests.\footnote{BLOOMBERG BNA, PORTFOLIO 741-2ND: REMICS, MORTGAGE REITS, MORTGAGE} The upper-tier REMIC

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    \item The upper-tier REMIC
  \end{itemize}
\end{itemize}
acquires all the regular interests in the lower-tier REMIC and issues classes of regular interests and a residual interest. 113 Essentially, a multiple-tier REMIC is where the upper-tier REMIC holds regular interests in one or two lower-tier REMIC interests. 114

Interests in the REMIC may be issued in the form of one or more classes of “regular interests” and only a single class of “residual interests.” Regular interests means:

|A|ny interest in a REMIC which is issued on the startup day with fixed terms and which is designated as a regular interest if . . . such interest unconditionally entitles the holder to receive a specified principal amount . . . and . . . interest payments . . . if any, with respect to such interest at or before maturity . . . [that] are payable based on a fixed rate (or to the extent provided in regulations, at a variable rate) . . . .

There are two types of variable rates permitted. The first is a “qualified floating rate” based on a “current interest rate,” typically LIBOR. 116 The second is based on the “weighted average rate” of mortgages within the pool. 117 “A regular interest in a REMIC may be issued in the form of debt, stock, an interest in a partnership or trust, or any other form permitted by state law.” 118

Conversely, “residual interest” is normally not an obligation principally secured by an interest in real property 119 and “need not entitle the holder to any distributions from the REMIC.” 120 Typically, the residual interest represents the income of the REMIC that is left after the holder of the regular interests has been paid. 121 Under the PSA, the holders of a REMIC’s residual interest are typically “the recipients of any assets remaining after the liquidation and termination of the REMIC.” 122 However, where the pool of mortgages is made up of PMs, the residual interest will be more sought-after.

Assuming the PMs in the pool are structured like the one outlined above,
classes of regular interests could be issued based on the payments of the principal and the floating interest rate. Because the PM’s floating interest rate is based on LIBOR, it would be permissible under 26 C.F.R. § 1.860G–1 (a)(3). The payments of the principal and floating interest rate could be issued in different classes including principal only (POs) and interest only (IOs) strips. The key challenge is what to do with the contingent SIMs and SAMs.

Under the current regulations, SIM and SAM backed securities would be issued as a residual interest.\(^{123}\) Unlike the typical “residual interest,” SIM and SAM based interest would be highly sought after and have the potential to produce greater yields while remaining relatively safe investments. However, because the regulations only allow for a REMIC to issue a single residual interest, the PSA might call for the SIM and SAM to be pooled together in a non-REMIC “taxable mortgage pool.”\(^{124}\)

The owner could retain the SIM and SAM rights, then strip and deposit the fixed and floating interests into a REMIC.\(^{125}\) The SIM and SAM could be held or put into a separate non-REMIC pool. While it is clear the pool would not receive the same tax benefits as a REMIC, it would allow for pooling of SIMs and SAMs without the fear of violating the only one residual interest rule.

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\(^{123}\) Real Estate Mortgage Investment Conduits, 57 Fed. Reg. 61,293 (1992) (“The final regulations also make it clear that certain obligations that contain contingent payment provisions can be stripped of the contingent payment rights and the holder of those rights will not be considered to hold an interest in the REMIC. Thus, for example, if a loan not only has a fixed principal amount and provides for interest at a fixed rate, but also contains a shared appreciation provision, the holder of the loan can contribute the fixed payment rights to a REMIC and retain the shared appreciation rights[,] and those retained rights will not be considered to be an interest in the REMIC. Of course, the owner could have contributed the entire loan to the REMIC and taken back a residual interest that consisted of the right to the contingent payments.”).


Further, if an obligation with a fixed principal amount provides for interest at a fixed or variable rate and for certain contingent payment rights (e.g., a shared appreciation provision or a percentage of mortgagor profits provision), and the owner of the obligation contributes the fixed payment rights to a REMIC and retains the contingent payment rights, the retained contingent payment rights are not an interest in the REMIC.
governing REMICs. Additionally, the use of a taxable mortgage pool would allow for commercial mortgages to contain both SIM and SAM provisions.

The question of what SPV to use will ultimately be a question left to the market in deciding whether the securitization of SIM and SAM outweighs the tax burdens on a non-REMIC pool. However, it is the Authors’ opinion the REMIC regulations should be amended to classify contingent interest features based on net-operating income, and appreciation as permitted variable interest rates so multiple classes of SIMs and SAMs may be issued from non-taxed mortgage pools.

b. Servicing.

After the loans are pooled, it is essential they remain qualified obligations. This means keeping the payments coming to the pool and the investors. To accomplish this, the PSA contains a servicing agreement that grants authority to servicers to collect on the mortgage loans. The key provisions of the servicing agreement include: the procedures for servicing, obligations and rights of the servicers, allocation of profits and losses, protection of tax treatment, and maintenance of records. The PSA typically includes two servicers, a master servicer (MS) and a special servicer (SS) who are fiduciaries of the SPV and the investors. The MS handles loan administration for performing mortgage loans, while the SS has primary responsibility of servicing nonperforming loans or loans where default is imminent. Their roles will vary depending on whether they are servicing residential or commercial mortgages.

The main function of the MS is to collect payments due on the mortgage. The MS then forwards those funds to the REMIC, or other SPV, so the investors may be compensated. If there are payment shortfalls due to

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127 Id.
129 FRANKLIN & NEALON, supra note 78, at § 1:16.
130 Id.
131 Kronovet, supra note 128, at 309.
delinquencies or defaults, the MS has a duty to cover those payments and advance funds to the SPV so the investors may be paid.\textsuperscript{132} In addition, the MS will: advance capital to pay property taxes and insurance premiums; monitor cash flow of commercial real estate and the properties’ value; and report such information to investors, underwriters, and rating agencies.\textsuperscript{133} For the purposes of PMs, the role of the master servicers will remain relatively the same. However, collections for SIM and SAM may require a more fact intensive approach than typical servicing.

The PSA must grant the MS sufficient authority to collect the SIM and SAM rates. The SIM provision in particular will require the MS or its agent to perform an investigation into the commercial borrowers’ financial records to determine the actual net operating income and pay the appropriate amount to the investors. Likewise, SAM provisions will require the MS or its agent to perform appraisals that may give rise to disputes with the borrower such that mediation would be required. These concerns and additional due diligence requirements should be mandated under the duties, covenants, representations, and warranties of the MS.

The SS handles loans in default or nearing default.\textsuperscript{134} The “precise circumstances under which the main servicing responsibility passes from the [MS] to the [SS] are carefully described in the PSA[,] and the hand-off is typically referred to as a [s]pecial [s]ervicing [t]ransfer [e]vent.”\textsuperscript{135} Transfer events include: sixty day payment delinquencies, other defaults or the servicer’s judgment that a default is reasonably imminent, the insolvency of the mortgagor, the default of any additional indebtedness on the mortgaged property, or borrower’s interest in the mortgaged property, and the mortgagor’s admission of its inability to pay its debts.\textsuperscript{136} Once the loan is transferred to the SS, the MS is no longer required to advance capital to the SPV to cover shortfalls.\textsuperscript{137} Therefore, holders of regular and residual interests must wait for a work-out or liquidation of the non-performing loan.\textsuperscript{138}

Default for PMs includes non-payment of the principal, floating interest, or SIM and SAM. The SS would follow the terms of default in the PM as outlined in the default section above. However, the SS should be granted the

\textsuperscript{132} Kronovet, supra note 128, at 309.
\textsuperscript{133} Id.
\textsuperscript{134} FRANKLIN & NEALON, \textit{supra} note 78, at § 1:16.
\textsuperscript{135} Id.
\textsuperscript{136} Id.
\textsuperscript{137} Kronovet, \textit{supra} note 128, at 310.
\textsuperscript{138} Id.

\textsuperscript{132} Kronovet, \textit{supra} note 78, at § 1:19.
authority to decide which of the three scenarios resulting in default of the SIM occurred and which actions need to be taken to correct the default. Additionally, the SS needs the authority to negotiate the terms of SIM loans to get the loan performing again and get the holders of the residual interest the highest return practicable. Likewise, the SS needs the authority to get another appraisal if the borrower rejects the first appraisal and does not pay the SAM rate.

iv. Offering Documents, Disclosure, and Securities Regulations

The final stage of the process is offering the interests in the mortgage pools, particularly the SIMs and SAMs, as securities to investors. This section will cover the offering process, documents, and registration where the underlying properties are commercial. The PMBS offering described here is similar to any other CMBS offering aside from additional disclosures relating to the SIM and SAM based residual interests. The policy behind federal securities law and regulation “is to ensure fair and full disclosure of information regarding the security and the issuer so that the reasonable investor can determine the relative merits of the security.” 139

For the purposes of PMBS, the offerings detailed here will be both private and public. The issuer may offer securities to investors in a public offering, a private placement, or both. 140 Each type of offering has its own regulations and guidelines to ensure adequate disclosure for the protection of potential investors. 141 Generally, under Section 5 of the Securities Act of 1933, unless either the security or the transaction is exempt, no security can be offered unless a registration statement has been filed, is effective, and proceeded by a prospectus. 142

Under the 1933 Act, Section 4(2) private offerings to “qualified institutional investors” are exempt from the registration requirements. 143 Qualified institutional investors are “sufficiently sophisticated” and “do not need the protection of the federal registration requirement.” 144 Rule 144 then allows the qualified investor to trade and sell unregistered securities under the

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139 Id. at 300.
140 FRANKLIN & NEALON, supra note 78, at § 1:48.
141 Id.
143 Kronovet, supra note 128, at 300.
144 Id.
exemptions in Sections 3 and 4 of the 1933 Act.\textsuperscript{145} However, such institutional investors are still subject to the antifraud provisions of the 1933 and 1934 Securities Acts.\textsuperscript{146} Meaning, Section 10(b) and the corresponding Rule 10b-5 anti-fraud provisions apply.\textsuperscript{147} Therefore, even in a private offering, it is recommended that disclosure in the offering memorandum meets the standards expected in a public offering. Under the 1933 Act, public offerings of CMBS are commonly issued through shelf offerings, permitted under Rule 415 of the 1933 Securities Act.\textsuperscript{148} In a public offering, the issuer must first file a registration statement with the SEC before offering the securities to investors.\textsuperscript{149} The filing must comply with the requirements of the 1933 Act and other regulations, including Regulation AB and blue sky laws.\textsuperscript{150}

In a shelf registration, the registration of securities can be publicly offered on a delayed or continuing basis.\textsuperscript{151} Shelf registration requires an initial registration with the SEC upon creation and on a continuing basis to reflect current information on the mortgage pool.\textsuperscript{152} The initial registration statement is filed with a base prospectus that sets forth a general description of the securities to be issued.\textsuperscript{153} It is accompanied by a prospectus supplement that serves as a template for prospectus filed with each subsequent offering.\textsuperscript{154} With each offering, a separate prospectus supplement discloses information specific to the new securities.\textsuperscript{155} The supplement, together with the original prospectus, is then filed with the SEC and delivered to investors.\textsuperscript{156}

The issuer must warrant that representations made in the prospectus and other filings "are not materially misleading."\textsuperscript{157}

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\textsuperscript{145} Fagan & Frankel, supra note 77, at 288.
\textsuperscript{146} Id. at 299.
\textsuperscript{147} Kronovet, supra note 128, at 300–01.
\textsuperscript{148} Id. at 301.
\textsuperscript{149} FRANKLIN & NEALON, supra note 78, at § 1:48.
\textsuperscript{150} Id.
\textsuperscript{151} Kronovet, supra note 128, at 301 ("Offerings made with a shelf registration are used because of the interest rate risk associated with the length of time required to assemble a pool of commercial real estate mortgages. The shelf registration process allows the issuer to satisfy the registration requirements of the 1933 Act at the same time as it acquires the commercial mortgages to be pooled. When the commercial real estate mortgages are assembled and pooled, the registration requirements have already been met and the interest rate risk has been averted.").
\textsuperscript{152} Id.
\textsuperscript{153} FRANKLIN & NEALON, supra note 78, at § 1:48.
\textsuperscript{154} Id.
\textsuperscript{155} Id.
\textsuperscript{156} Id.
\textsuperscript{157} Kronovet, supra note 128, at 302.
documents provide a “substantial amount of information regarding the mortgage loans and both an individual and pool wide basis.”\textsuperscript{158} Larger loans are more detailed and include information about the terms of the loan.\textsuperscript{159}

The initial and subsequent prospectus will disclose any material concentrations of common characteristics within the mortgage pool, including concentrations of mortgaged properties in a particular geographic area or industry.\textsuperscript{160} The offering document should also disclose any material features of the mortgage loans or properties that might affect the payments or cause the characteristics of the mortgage pool to change.\textsuperscript{161} This is where specific terms of the PMs and the mortgaged properties would be most detailed. The documents should describe particular provisions of the PM, including the SIM, SAM, defeasance provisions, and payments due thereunder.\textsuperscript{162}

Investors should be aware of the possible yields and the respective timing of payments under the SIM and SAM provisions, as well as consequences and remedies for default. The offering documents must also describe the structure of the PMBS, including: priority of payments, application of losses and shortfalls, the classes and ratings of securities, principal balances, expected maturity dates, and distribution dates.\textsuperscript{163} The offering document provides disclosure regarding risks present in investing, including any unusual risks relating to the particular pool or portion of the pool and risks related to the structure of the securities.\textsuperscript{164} It will also explain the risks associated with investing in commercial real estate generally and that the investor assumes such risks.\textsuperscript{165}

For the purposes of PMBS, the disclosure regarding any classes created on the payments of principal and floating interest will be similar to those in CMBS offering documents described above. However, additional disclosure will be required for those investing in the residual interests in the SIM and SAM provisions. Such additional information should describe the contingent nature of the payments and the terms of default.
IV. Conclusion

Because properly drafted PMs have the ability to be securitized, they should be more attractive to lenders and borrowers after the financial crisis of 2009. PMs offer an ethical alternative to lending, one based on shared risk and that offers the possibility of greater returns. However, for the PMs outlined above to become truly viable alternatives to traditional mortgages, they need to be re-introduced in the new mortgage markets with more favorable regulations. Legal academics and lawyers in real estate finance need to reexamine this alternative lending arrangement as much has changed since its first introduction over two decades ago. This means taking a critical look at usury laws affecting the drafting and regulations hindering the tradability of mortgages with contingent interest features. Such hurdles need to be reevaluated and removed to allow these ethical lending arrangements to grow and reach the broader public.