Who looks after noteholders? CMBS crisis exposes conflicts

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The notion that servicers owe a duty of care to CMBS investors has been vigorously challenged in the past months in the UK, most conspicuously in the **Titan 2006-4 Four Seasons** deal, where this duty has been expressly rejected. Some servicers and CMBS professionals are now trying to fight back, but there is a great deal of confusion.

When CMBS transactions were marketed, each class of bondholder was told that it would wield some form of control. This was good enough in the old days but the financial crisis has provided a reality check. Since the onset of the crisis, countless conversations have taken place on panel sessions on the structured finance conference circuit, as practitioners have sought to define the respective roles of the servicer and the trustee.

The consensus on these occasions is usually that servicers, while they have a duty of care towards noteholders and have to take into account their interests, are essentially charged with maximising recoveries on the loans to the lenders on a net present value basis. Trustees, on the other hand, have to deal with noteholders and act on their behalf.

That division does not cause problems when both noteholders and the servicer agree that recoveries are likely to be better in a few years' time and choose to take no action. But when restructuring cannot be postponed, there is room for friction between those different mandates.

This was the case for Titan 2006-4 Four Seasons, a hybrid CMBS backed by care homes operated by the Four Seasons Health Care Group, as the notes neared their maturity date.

Negotiations were particularly tricky as hedge funds had managed to build blocking positions. To secure the approval of these holdouts, the restructuring team of Gleacher Shacklock, which was working for the borrower, devised a strategy based on the lack of formal duty of care owed by the servicer to noteholders.

By limiting market disclosures to the bare minimum, they managed to keep in place until the voting day the lock-up agreement signed with a large number of bondholders, while providing a separate exit route for some holdouts through a purchase agreement negotiated with Deutsche Bank – with a small fraction of the price being funded by the Four Seasons Healthcare Group.

Nassar Hussain, a managing partner at advisory and restructuring boutique Brookland Partners, who advised the servicer on the deal, believes the approach followed by the borrower was likely to be a one-off, as the whole process was driven by the borrower and its advisers (not the servicer) and the disclosure in connection with the potential acquisition of certain noteholder positions was made after a number of the other investors had already signed lock-ups.

Hussain is certain that servicers should take into account the interests of noteholders. “To say that servicers have no direct duty of care to noteholders is technically correct, but in reality and in practice this is wrong,” he said.

“The servicers owe a duty of care to the issuer, which is an SPV. Noteholders (provided they broadly act in unison) together with the trustee have the ability to ask the issuer to sue the servicer. This is a right that is actionable and servicers are increasingly wary of this litigation risk, as well as the ability of the controlling class to replace special servicers if they are unhappy with the performance of the special servicer.”

In his view, the main consequence of the Titan Four Seasons restructuring is that investors may become more reluctant to sign lock-up agreements in the future.

The RBS-arranged single-loan synthetic CMBS **EPIC (Industrious)** is another contentious deal. For months there has been talk that RBS, the sponsor and servicer, will be sued by investors. But lawyers are unsure whether any lawsuit would be successful. “Any claim would have to establish that RBS owed some sort of duty of care to the bondholders”, which would be tricky to prove, said one structured finance lawyer.

Officials at the servicers themselves insist that, as much as possible, they take account of the interests of all the parties involved.

“Our view has always been that while others may be our legal client, the noteholders are economically in this position and we therefore try to ensure that, while staying within the powers given to us, we take into account their interests to the best of our ability,” said David C Martin, director of special servicing at CB Richard Ellis Loan Servicing Limited.

Gareth Allatt, a director at Barclays Capital Mortgage Servicing, makes a similar point. “The contracts we have in place with the trustee and issuer effectively place us under a duty of care to all noteholders,” he said.

“Whilst at a technical level the servicer’s contractual nexus is with the issuer and trustee (as opposed to the noteholders directly), we sign up to maximising recoveries with due regard for minimising costs and having regard for the timing of making recoveries for the capital stack as a whole.”

Evolving market

Whatever the details of the servicing contracts, there will always be conflicts of interest between different types of investors and classes of bondholders, and there will also be cases when the servicer will find that disclosure should be limited in order not to jeopardise the sale of assets.

What is clear is that the market will adjust the way it deals with these issues in the light of the tensions exposed by the crisis. One possibility is a redefinition of the roles of trustees and servicers along the lines of the French system.

In France, an entity manages the funds (SPV without incorporation) that have issued the notes, acts as trustee and performs some of the tasks carried out in the UK by servicers. It also performs the cash manager role, and the reporting, calculation and operational agents' duties.

Nicolas Noblanc, head of the legal department at French fund manager EuroTitrisation, said: "One of the key advantages for bondholders is that by centralising the different roles, the French system makes it easier for investors to see who is in charge. Extreme cases seen in the UK where both the trustee and the servicer appear to disregard the noteholders' interests could probably not occur under the French system."

Whatever the model followed, if the European CMBS market re-emerges, documentation will have to be clearer, particularly with regard to controlling rules, market participants agree.

According to Jayne Black, a partner in law firm Berwin Leighton Paisner's finance team, the current arrangements are "too opaque". "More transparency on controlling rights is needed. You have to make clear how the decisions are made and servicers need to be expressly given more authority for analysing the impact of their decisions at the note level, rather than focusing solely on the loans."

However, she added, servicers could not deliver the impossible and could not be expected to reconcile a wide array of often conflicting interests.

Jean-Marc Poilpre