CMBS Disputes On The Horizon?

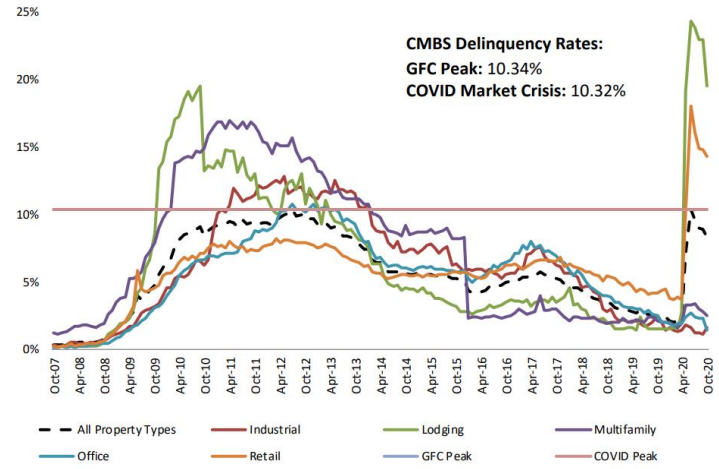
April 2021 Outlook

The pandemic has justifiably renewed concerns about the fragility of the CMBS market and the possibility of a new, commercial, mortgage crisis. While government support, fiscal stimulus and short-term debt relief have temporarily scaffolded many businesses, commercial real estate—and therein CMBS—continues to face gale-force headwinds. Although CMBS delinquency rates have begun to recover from their mid-2020 peak, the COVID-19 crisis, like a receding tide, is continuing to expose systemic flaws related to the origination, underwriting and rating of CMBS loans, prompting early-stage litigation.

In June of 2020, we issued a client alert discussing potential CMBS litigation arising out of the 2020 downturn. As we noted in that alert, given our extensive expertise in ground-breaking RMBS and CDO litigation and lead role in high-profile CMBS disputes, Quinn Emanuel is well positioned to take a lead role in CMBS-related litigation arising from the pandemic. We are monitoring developments in the space and continue to evaluate various potential claims and defenses. This supplemental update surveys burgeoning issues and litigation in the CMBS industry as of April 2021.

1. The Economic Downturn's Impact on The CMBS Market

As we reported in our June 2020 client alert, the CMBS market faced a huge and sudden challenge in the COVID-19 pandemic. The market downturn caused by COVID-19 was an unexpected shock that resulted in a complete shutdown of travel and a substantial curtailment of commercial office and retail utilization. U.S. lodging, retail and office commercial properties were particularly hard hit, causing the fastest rise in delinquency rates in CMBS history, with 30+ day delinquency rates hitting a near all-time high of 10.32% by June 2020, three months into the lockdown.[1]



Source: Trepp

While many property owners are continuing to adapt to this unpredictable environment, we expect the impact on CMBS to be ongoing and significant. Nor has there been any suggestion that government action will directly address the issue. Although the U.S. Fed has injected billions of dollars into the economy by buying agency-Mortgage Backed Securities, the rescue programs have largely steered clear of CMBS, with the exception of triple-A rated CMBS that are eligible for TALF 2.0.[2]

2. Current State of The CMBS Market and 2021 Outlook

A year after the COVID-19 outbreak began, the industry has demonstrated resiliency and experienced a recovery in delinquency rates. In early 2020, Fitch expected the U.S. CMBS delinquency rate to peak between 8.25% and 8.75% in 2020. However, the rate peaked at only 5.0% in July 2020 thanks to short-term debt relief and fiscal stimulus supported by the government. Fitch claimed that the rate would have been much higher if the loans that were granted relief had become delinquent.[3]

Last month, Fitch Ratings' U.S. CMBS delinquency rate declined, for the fourth consecutive month, to 4.33%, with most of the major property types reporting lower delinquency rates from the previous month. Resolution volume also increased with nearly 60% of February's resolution ($1.3 billion) supported by modifications and COVID-19 debt relief.[4]

For the future, Fitch has projected further improvement driven by additional stimulus and acceleration in vaccinations. The predicted U.S. delinquency rate at the end of 2021 is below 4.0% with expected volatility during the first half of the year.[5] S&P also reported that U.S. CMBS delinquency and forbearance rates have stabilized but remain elevated after their mid-2020 peak.

Credit performance across property types remains uneven, however. According to S&P, while retail and lodging account for the majority of delinquencies, office and multifamily sectors should be closely monitored as well.[6] Trepp noted in its February 2021 report that while the overall special-

servicing rates are decreasing, the number of loans newly transferred to special servicing saw an increase of 16% over the previous month, with 66% of this increase reflected in the lodging and retail sectors.[7]

While short-term delinquency data, vaccinations and the promise of further government support are creating optimism in the minds of some analysts, other commentators are raising red flags about structural flaws in the origination and underwriting of certain CMBS loans, and early-stage litigation has appeared throughout the sector.

3. CMBS Litigation

Although the CMBS market has displayed surprising resilience through the pandemic, there has also been a steady drumbeat of warnings regarding troubling origination and underwriting practices impacting the long-term stability of the market. For example, as we previously noted, in 2019, SEC whistleblower John Flynn, a veteran of the CMBS industry, alleged that some of the world's largest banks and servicers systematically overstated properties' value and borrowers' creditworthiness to give borrowers larger loans than they would otherwise receive.

In May 2020, independent journalists at ProPublica, a non-profit news outlet, released an article suggesting that some of the world's biggest banks, Wells Fargo and Deutsche Bank included, had inflated net operating income and other metrics in order to originate oversized loans backed by bloated property valuations. Based on ProPublica's review of a sample of recent CMBS, some buildings' profitability was inflated by as much as 30%, resulting in a significantly larger mortgage.[8] ProPublica also confirmed some of Mr. Flynn's allegations, specifically including overstated net operating income ("NOI"), occupancy rates, and understated levels of debt.[9]

In August 2020, Professors John M. Griffin and Alex Priest at the University of Texas published a study in which they concluded that "CMBS loans hav[e] significantly lower-than-advertised origination quality."[10]

First, they studied 39,522 CMBS loans originated between 2013 and 2019 and compared underwritten NOI at the time of issuance and the first-year realized NOI. They found that realized NOI was at least five percent lower than the underwritten income in 28% of loans and concluded that "[t]here are economically sizeable and persistent differences in income overstatement across loan originators, with some originators . . . having more than 35% of their loans exhibiting 5% or greater income overstatement. . . ."[11] Their paper contends that underwritten NOI is systematically inflated because it is based heavily on inflated historical income, which is reported by the incentivized borrower as part of the underwriting process to an originator that is not compensated based on the loan's future performance.

Notably, the underwritten NOI is not limited to use in assessing the income-producing capability of a property directly, or to get a fix on potential sustainable cash flows. It is also used to calculate the ratios of the loan's debt service coverage and loan-to-value, two of the key metrics used to assess the riskiness of a loan. Overall, the authors noted, there is an "economically and statistically significant relation between originator income overstatement and distress," and "COVID is accelerating existing origination weaknesses."[12]

Second, the researchers found that 92% of properties in a sample of 6,820 had an appraisal value at or above the transaction price, and that those with an appraisal value more than 10% higher than the transaction price were 4.7% more likely to become distressed.[13]

The authors observed that even though CMBS 2.0 have generally performed well thus far, the fault lines created by these weaknesses in underwriting standards exist and may be revealed in periods of stress. Government subsidies to support the CMBS industry may delay the discovery of serious problems by shoring up all originators, including those who are relying on heavily overstated NOI and appraisals. Or they may exacerbate the crisis by putting taxpayer money behind the most appealing loans, those which are based on the most inflated numbers and therefore the most risky.

Against this rising tide of warning signs, a number of other developments point to increased dispute volumes in the CMBS market.

4. CMBS Ratings Manipulation And CRE Stock-Drop Litigation

On February 16, 2021, the Securities and Exchange Commission filed a complaint against Morningstar Credit Ratings, LLC, alleging that Morningstar inflated its ratings by secretly permitting its analysts to ease the stresses used in their "Subordination Model" on a loan-specific basis. According to the complaint, easing those stresses lowered the projected losses and therefore made CMBS appear less risky than they are.[14] This in turn justified higher ratings, which Morningstar then provided to benefit issuers that hired and paid it. The complaint further alleged that these loan-specific adjustments to the stresses used in the model were not tracked internally, such that they may be used whenever it benefited Morningstar to provide an issuer with an inflated rating. The case highlights familiar conflicts of interest in the rating infrastructure for asset-backed securities—the same conflicts of interest that previously contributed to the Great Financial Crisis.[15]

In addition, starting in October 2020, a series of securities cases have been filed based on allegedly misleading statements that concealed the true quality and riskiness of CRE or CMBS assets.

The first in the series was *Peters v. Colony Credit Real Estate, Inc. et al.*, Case No. 2:20-cv-08305 (C.D. Cal. Sep. 10, 2020), styled as a class action. The complaint alleges that shareholders were damaged by purchasing Colony Credit stock because of materially false and misleading statements the company made in its Registration Statement in connection with its merger about the quality of several of its real estate loans. The plaintiffs claim that certain of the company's loans were impaired and unlikely to be repaid, which overstated the valuation of the Company's assets, which in turn materially overstated the financial condition of the company. Thus, the plaintiffs allege, the company's reassuring statements were materially false and misleading and/or lacked a reasonable basis.

Since then, five securities cases have been filed against Wells Fargo targeting allegedly improper origination, underwriting, and securitization of CMBS and CLO loans. Two of them are class actions, and three are derivatives actions, but all have similar allegations. Essentially, these complaints allege:

(a) That Wells Fargo had systematically failed to follow appropriate underwriting standards and due diligence guidelines in issuing billions of dollars' worth of commercial loans, including by inflating the net income and future expected cash flows of its commercial clients to justify issuing excessive loan amounts;

(b) That a materially higher proportion of Wells Fargo's commercial loan customers were of poor credit quality and/or at a substantially higher risk of default than disclosed to investors;

(c) That Wells Fargo had failed to timely write down commercial loans, CLOs and CMBS on its books that had suffered impairments;

(d) That Wells Fargo had materially understated the reserves needed for expected credit losses in its commercial portfolios;

(e) That Wells Fargo had systematically misrepresented the credit quality and likelihood of default of the loans it packaged and securitized into CLOs and CMBS, including by artificially inflating the net income and expected cash flows of its commercial clients in loan and securitization documentation;

(f) That the CLO and CMBS-related loans issued and investment securities held by Wells Fargo were of lower credit quality and worth far less than represented to investors;

(g) That as a result of (a)-(f) above, Wells Fargo's . . . statements regarding the credit quality of its commercial loans, its underwriting and due diligence practices, and the value of its CLO and CMBS books were materially false and misleading; and

(h) That as a result of (a)-(g) above, Wells Fargo was exposed to severe undisclosed risks of financial, reputational and legal harm, in particular in the event of significant and sustained stress in the commercial credit markets.[16]

While Wells Fargo's history of alleged fraudulent business practices—catalogued in several of these complaints—likely made Wells Fargo an attractive early target, we would not be surprised if similar cases are brought against other financial institutions in the coming months.

5. Mezzanine Lender Actions

While many states have imposed foreclosure moratoriums covering commercial real estate, those moratoriums typically do not prevent mezzanine lenders from initiating equity foreclosures under UCC Article 9—where they take equity ownership of a special-purpose company that holds a commercial real estate asset (rather than foreclosing on the asset itself). *See, e.g.*, *D2 Mark LLC v. Orei VI Invs. LLC*, 2020 WL 3432950 (Sup. Ct. N.Y. Cty. June 23, 2020) (enjoining mezzanine lender with a junior loan position from foreclosing on the collateral, the Mark Hotel, upon minor default of a senior mortgage loan owned in part by a CMBS securitization trust).

Though state- or local-government moratoriums generally have not reached UCC Article 9 equity foreclosures, the pandemic has factored into courts' reasoning as to whether the auctions conducted in connection with these equity foreclosures are commercially reasonable. For example, in *D2 Mark*, the mezzanine lender scheduled an auction in June 2020 on thirty-six days' notice. The lender advertised the auction a month before the scheduled date, and the property was closed for inspection until nine days before the auction date. Based on these factors, and characterizing the statewide moratorium on commercial real estate foreclosures as "persuasive authority," the court granted a thirty-day stay and required the lender to give an additional thirty days' notice.

Likewise, in *Shelbourne BRF LLC v. SR 677 Bway LLC*, Index No. 652971/2020 (Sup. Ct. N.Y. Aug. 3, 2020), NYSCEF Doc. No. 38, the Court enjoined an auction until after October 15, 2020, applying the "logic" of a statewide moratorium prohibiting the scheduling of an auction or sale of property in any residential or commercial foreclosure. The court reasoned that "valuation of an equity interest in a company that owns real estate is based on the value of the real estate itself. Severe turmoil in the real estate market due to the pandemic makes the notion of a sale resulting in payment of fair market value highly uncertain." The court later denied a second preliminary injunction in October 2020 because the parties had expressly agreed to the sale in their contract, it concluded that "[g]iven

the circumstances of this case and the current state of the pandemic, further enjoining this sale would be highly inequitable." *Id.*, NYSCEF Doc. No. 81.

Meanwhile, New York's Appellate Division, First Department recently reversed the court's original decision on preliminary injunction for failure of the mezzanine borrower to show irreparable harm. Consistent with past precedent in CMBS preliminary-injunction cases, the appellate court explained that "the feared loss of an investment can be compensated in money damages." *Shelbourne BRF LLC v. SR 677 Bway LLC*, 2021 WL 816691, at *1 (N.Y. App. Div. Mar. 4, 2021). The more recent determinations in *Shelbourne* are consistent with two other cases, *1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC*, 2020 WL 2569405 (Sup. Ct. N.Y. Cty. May 18, 2020), and *893 4th Ave. Lofts LLC v 5Aif Nutmeg, LLC*, 2020 WL 4936913 (Sup. Ct. N.Y. Cty. Aug. 25, 2020), which simply ruled that equity foreclosures could proceed because the statewide moratorium did not prohibit them.

The takeaways from these cases suggest that generalized allegations about the pandemic will not be sufficient to challenge the commercial reasonableness of an equity foreclosure and associated UCC Article 9 auction. But more specific allegations challenging the method, manner, time, place, and notice may be successful in delaying an auction. As circumstances continue to improve with regard to the pandemic, successful challenges may become more difficult. But mezzanine borrowers and lenders should: (1) check CDC, state, and local guidelines to make sure that the method and manner of the auction complies with applicable rules and guidelines, (2) consider whether the statewide moratoriums provide any guidance for the appropriate method and manner of the auction, and (3) consider whether the auction allows the option of virtual inspections, due diligence, and auction participation.

6. Borrower-Initiated Litigations

Over the past six months, we have observed a substantial increase in borrower-initiated litigations against CMBS lenders. While taking many forms, these cases tend to involve allegations of misconduct by CMBS special servicers, who are accused of exploiting the pandemic to take improper benefits from distressed borrowers.

In *CityPlace Retail, LLC v. Wells Fargo Bank, N.A.*, 457 F. Supp. 3d 1318 (S.D. Fla. 2020), the borrower sought to use a purposefully low appraisal for its refinancing, so as to avoid paying $10.3 million in Net Refinancing Proceeds to the noteholders of the loan. To accomplish this, it declined to participate in the agreed-upon appraisal procedure in the agreement based on the Trustee's failure to notify the borrower of the identity of its Qualified Appraiser on time. The Court found that CityPlace's claim seeking court approval for using the low appraisal for the refinancing was barred by the doctrine of substantial forfeiture, under which "a Court may excuse a party's failure to comply with a contractual obligation if the failure would result in a 'disproportionate forfeiture,' and the failure to comply was not with respect to a condition that formed a 'material part of the agreed exchange.'" *Id.* at 1343. The Court considered the Trustee's missed notification in this case to be *de minimis*, resulting in no prejudice to CityPlace, whereas "the noteholders stand to lose millions of dollars over a technical, inconsequential delay." *Id.* at 1345. The Court further ruled that CityPlace's claim was barred because it breached its duty to cooperate in the appraisal process; because its own appraisal process was void due to its intentionally withholding information as to the proper value of the business; and because it breached its duty of good faith and fair dealing in the appraisal process. This case is currently on appeal to the Eleventh Circuit.

More recently, another dispute over excess cashflow arose, this time in the Western District of Pennsylvania. In *Gumberg Associates - Chapel Square v. Keybank National Association*, 2020 WL 7021473

(W.D. Pa. Nov. 30, 2020), the borrowers, owners and operators of Ohio's Northtowne Mall sought to enjoin the lenders for their CMBS loan from retaining "Excess Cash Flow" that would normally flow to them. "Excess Cash Flow" is defined as the money left after certain expenses are deducted from mall tenant rent payments. The lenders argued that when JC Penney left the mall, it constituted a third Tenant Trigger Event that borrowers could not cure under the parties' agreement, therefore triggering a Cash Sweep Period. In a Cash Sweep Period, lender was entitled to retain the Excess Cash Flow as additional security for the loan. The Court denied the borrower's motion for a preliminary injunction, finding that their losing temporary access to the "Excess Cash Flow" would not constitute irreparable harm. Last month, the case was remanded to the Allegheny County Court of Common Pleas after CMBS Trustee Deutsche Bank was joined as a party. *Gumberg Associates – Chapel Square v. Keybank National Association,* 2021 WL 492880, at *6-7 (Feb. 10, 2021); *see also AFP 108 Corp. v. Deutsche Bank Trust Company Americas, et al.,* Index No. 650121/2021 (Sup. Ct. N.Y. Cty. Jan. 7, 2021) (suit by CMBS borrower seeking to prevent CMBS trustee and special servicer from foreclosing on the collateral for a securitized CMBS loan); *PDQ 9604 Tops, LLC v. Rialto Capital Advisors, LLC, et al.,* Index No. 650073/2021 (Sup. Ct. N.Y. Cty. Jan. 6, 2021) (same).

* * *

If you have any questions about the issues addressed in this memorandum or otherwise, please do not hesitate to reach out to us.

Jonathan E. Pickhardt
jonpickhardt@quinnemanuel.com
+1 212 849 7115

Sascha N. Rand
sascharand@quinnemanuel.com
+1 212 849 7175

Diane Cafferata
dianecafferata@quinnemanuel.com
+1 213-443-3666

Isaac Nesser
isaacnesser@quinnemanuel.com
+1 212-849-7253

Anthony Alden
anthonyalden@quinnemanuel.com
+1 213-443-3159

Toby E. Futter
tobyfutter@quinnemanuel.com
+1 212 849 7431

Blair Adams
blairadams@quinnemanuel.com
+1 212 849 7615

---

[1] Trepp, *The Great Financial Crisis vs. COVID-19: The Impact on Commercial Real Estate & CMBS*, 2 (Oct. 2020), https://info.trepp.com/hubfs/Trepp%20Research%20-%20The%20Great%20Financial%20Crisis%20vs.%20COVID%20Disruption%20-%20October%202020.pdf.

[2] Robin Marshall and Luke Lu, *CMBS and the Fed…is there a crisis brewing in the office?*, FTSE Russell, 2 (Nov. 2020), https://content.ftserussell.com/sites/default/files/cmbs_and_the_fed...is_there_a_crising_brewing_in_the_office.pdf?_ga=2.3584822.727494377.1616175898-735676236.1616175898.

[3] Fitch Ratings, *U.S. CMBS Delinquency Rate Projected to Improve by YE 2021 Amid Volatility* (Jan. 27, 2021), https://www.fitchratings.com/research/structured-finance/us-cmbs-delinquency-rate-projected-to-improve-by-ye-2021-amid-volatility-27-01-2021.

[4] Fitch Ratings, *US CMBS Delinquencies Continue Downward Momentum in February* (Mar. 5, 2021), https://www.fitchratings.com/research/structured-finance/us-cmbs-delinquencies-continue-downward-momentum-in-february-05-03-2021.

[5] *U.S. CMBS Delinquency Rate Projected to Improve by YE 2021 Amid Volatility*, *supra* note 3.

[6] S&P Global Ratings, *Global Structured Finance 2021 Outlook: Market Resilience Could Bring Over $1 Trillion In New Issuance*, 31-33 (Jan. 8, 2021), https://www.spglobal.com/_assets/documents/ratings/research/100048329.pdf.

[7] Trepp, *February Sees Fifth Monthly Decline In Overall CMBS Special Servicing Rate*, 1 (Feb. 2021), https://www.trepp.com/hubfs/Trepp%20February%202021%20Special%20Servicing%20Report.pdf.

[8] Heather Vogell, *Whistleblower: Wall Street Has Engaged in Widespread Manipulation of Mortgage Funds*, ProPublica (May 15, 2020, 7:00 AM), https://www.propublica.org/article/whistleblower-wall-street-has-engaged-in-widespread-manipulation-of-mortgage-funds.

[9] *Id.*

[10] John M. Griffin and Alex Priest, *Is COVID Revealing a CMBS Virus?*, at 4 (Nov. 18, 2020).

[11] *Id.* at 2.

[12] *Id.* at 3.

[13] *Id.* at 4.

[14] Erik Larson, *Morningstar Tweaked Ratings of Paying Clients, SEC Claims*, Bloomberg (Feb. 16, 2021, 5:53 PM), https://www.bloomberg.com/news/articles/2021-02-16/morningstar-analysts-tweaked-ratings-of-paying-clients-sec-says?sref=mNvVwa7i

[15] Cezary Podkul and Gunjan Banerji, *Inflated Bond Ratings Helped Spur the Financial Crisis. They're Back.*, The Wall Street Journal (Aug. 7, 2019, 12:22 PM), https://www.wsj.com/articles/inflated-bond-ratings-helped-spur-the-financial-crisis-theyre-back-11565194951. This is not the first time the SEC has initiated enforcement actions against the ratings agencies for their alleged role in inflating the ratings given to asset-backed securities. In May 2020, Morningstar settled SEC claims that it had violated a conflict-of-interest rule that separates credit ratings and analysis from sales and marketing activities with regard to asset-backed securities. *SEC Orders Credit Rating Agency to Pay $3.5 Million for Conflicts of Interest Violations,* U.S. Securities and Exchange Commission (May 15, 2020), https://www.sec.gov/news/press-release/2020-112. In September 2020, Kroll Bond Rating Agency settled SEC claims that its analysts made adjustments on CMBS deals without rationale for those changes, and that its internal control structure failed to prevent or detect the ambiguity in Kroll's record of its methodology for making those changes. *SEC Charges Ratings Agency With Internal Controls Failures In Connection With Ratings of CMBS and CLO Combo Notes*, U.S. Securities and Exchange Commission (Sep. 29, 2020), https://www.sec.gov/news/press-release/2020-235.

[16] Compl. 27-28, *Mullen v. Wells Fargo & Company, et al.*, Case No. 3:20-cv-07674 (N.D. Cal. Oct. 30, 2020); *see also* Compl. 30-31, *Wood v. Wells Fargo & Company, et al.*, Case No. 3:20-cv-07997 (N.D. Cal. Nov. 13, 2020); Compl. 31, *Cotton v. Scharf, et al.*, Case No. 3:20-cv-09169 (N.D. Cal. Dec. 17, 2020); Compl. 6-7, *Montini Family Trust v. Scharf, et al.*, Case No. 3:20-cv-08752 (N.D. Cal. Dec. 10, 2020) (alleging Wells Fargo lent to businesses that "posed a heightened risk of default" and "systematically concealed these credit risks by artificially inflating the incomes generated by borrowing businesses, failing to follow proper underwriting procedures, and evading applicable risk controls"); Compl. 6-7, *Himstreet v. Scharf, et al.*, Case No. 3:20-cv-08750 (N.D. Cal. Dec. 10, 2020) (same).