



## Take Another B-Piece of My Heart, Now Baby



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In pooled commercial mortgage-backed securities (“CMBS”) transactions, typically called “conduit” transactions, and some single-asset (“SASB”) transactions, a single entity typically purchases one or more classes of certificates that represent the entirety of the first-loss portion of the securitization. This entity is referred to as the “B-Piece Buyer,” because it purchases the unrated and lowest-rated (in conduit transactions, typically “B” or “B-”) classes of the securitization. Additionally, in certain transactions, the B-Piece Buyer also acts as the “third-party purchaser” under the risk retention rules, which permit a sponsor to satisfy its risk retention obligation through the purchase of the first-loss portion of a transaction by an unaffiliated party. Because the B-Piece Buyer has a greater risk of loss than investors in the more senior classes of a CMBS transaction, it has certain rights both before and after securitization that extend much further than the rights granted to the more passive senior investors.

### **Before Securitization**

A CMBS conduit transaction cannot get off the ground without a B-Piece Buyer. Unlike the investors in the other classes of the CMBS transaction, the B-Piece Buyer is identified and generally commits to the deal (subject to certain parameters and qualifications) before servicing parties have been selected, any offering materials have been printed or the pool of loans serving as collateral has been finalized. Once a B-Piece Buyer agrees to be part of a particular deal, the B-Piece Buyer takes an active role in shaping the collateral pool and the terms of the transaction. It conducts an independent review of the credit risk of each loan and has the right to veto loans proposed by the lenders for inclusion in the pool, and its sign-off on the final pool is necessary for the transaction to move forward. If the B-Piece Buyer is acting as third-party purchaser for the transaction, its review also satisfies risk retention requirements: each third-party purchaser conducts an independent review of the credit risk of each securitized asset prior to the sale of the asset-backed securities in the securitization transaction that includes, at a minimum, a review of the underwriting standards, collateral, and expected cash

flows of each commercial real estate loan that is collateral for the asset-backed securities. In addition, as a condition to joining the deal, a B-Piece Buyer will often stipulate how much of the loan pool can consist of loans secured by certain property types or have similar requirements. The B-Piece Buyer also receives drafts of the servicing documents and negotiates the provisions relating to the control it will have over the pool assets after the securitization closes.

While some SASB transactions also have B-Piece Buyers, they are not ubiquitous as they are in conduit transactions, and a SASB issuer who is not relying on a B-Piece Buyer to act as third-party purchaser may not have a B-Piece Buyer in the transaction at all, in part because the first loss class of a SASB often has an investment-grade rating.

### **After Securitization**

CMBS conduit pooling and servicing agreements provide that, as long as the principal balance of the classes the B-Piece Buyer holds are not reduced below the “control” thresholds described below, they have a set of rights that other certificateholders do not. One of those rights is the ability to provide feedback and approval to any proposed loan modifications or workouts. When a loan becomes specially serviced, the special servicer is required to prepare an “asset status” report describing the current state of the loan and how the special servicer proposes to resolve the loan default. The B-Piece Buyer reviews this report, and the report and proposed plan of action are only final once the B-Piece Buyer approves them, subject to the special servicer’s ability to take emergency action without waiting for B-Piece Buyer approval if it determines that it is necessary to protect the certificateholders from potential harm.

In addition, as long as it has control, the B-Piece Buyer has consent rights over “major decisions.” While the scope of the so-called “major decisions” varies to some degree from deal to deal (and is often negotiated by the B-Piece Buyer prior to the securitization closing), generally any matter in a loan agreement relating to modifications or waivers to the documents or the lender’s exercise of remedies falls within the scope of the B-Piece Buyer’s review and approval.

The special servicer – the servicer specifically responsible for loans that have defaulted or are at significant risk of default (and often an affiliate of the B-Piece Buyer) – is replaceable at will by the B-Piece Buyer as long as the B-Piece Buyer has control rights, and so even special servicer decisions that are not explicitly subject to B-Piece Buyer consent rights can be subject to B-Piece Buyer influence through its relationship with the special servicer.

### **Changes in Control and Loss of Control**

While a B-Piece Buyer’s influence over a securitization is significant, it is not necessarily permanent. There are several ways a B-Piece Buyer can lose its control powers and the right to appoint a new special servicer. First, it can sell its certificates. The powers granted under the pooling and servicing agreements are exercisable by whatever entity owns the majority of the class of certificates designated as the controlling class, and so a buyer of that class steps into the B-Piece Buyer’s shoes. If the B-Piece Buyer is holding the controlling class as a “third-party purchaser,” it is prohibited from transferring its certificates to an unaffiliated buyer, except for a single transfer to an unaffiliated buyer at least five years after

the securitization closing date, but the transactions that do not use this risk retention structure have first-loss certificates that can be freely transferred to subsequent investors at any time.

Second, the B-Piece Buyer can lose its control through its affiliations with a borrower party. If the B-Piece Buyer is affiliated with a borrower, a property manager or the holder of a mezzanine loan that has been accelerated or as to which the lender has instituted enforcement or foreclosure proceedings, then the B-Piece Buyer ceases to have control or consent rights with respect to the impacted loan for as long as the affiliation continues.

Finally, a B-Piece Buyer can lose its powers through the application of realized losses to the certificates and the nominal reduction of the balances of its certificates through the application of appraisal reduction amounts. When the aggregate outstanding principal amounts of the mortgage loans are less than the aggregate principal balances of all classes of certificates, the resulting shortfall is applied to reduce the principal balance of each class of certificates, beginning with the first loss class.

Appraisal reductions occur when certain events indicating that a loan is in distress trigger an appraisal of the underlying property, and if the appraisal indicates that the appraised value is lower than the balance of the loan. The classes of certificates are nominally reduced to reflect anticipated losses in the event of a foreclosure, beginning with the first-loss class and moving upward through the classes based on their relative subordination. If the class of certificates previously designated as the controlling class, after having its balance reduced by principal distributions, realized losses and appraisal reductions, has less than 25% of its original principal balance, then control shifts to the first loss class of certificates that still has a control appraisal-reduced principal balance equal to at least 25% of its original principal balance; however, only a small number of the junior classes are so-called "control-eligible" classes, and if none of them has an adequate principal balance, control is shut off entirely.

When control is shut off, the holder of the first loss outstanding class retains limited consultation rights with respect to loan modifications, workouts and major decisions, unless the class balance, as reduced by principal distributions and realized losses, is less than 25% of the original balance, in which case the consultation rights, like control rights, move to the next most subordinate class and if no control-eligible class has a sufficient balance outstanding, are also terminated. When control and consultation are terminated, no class of certificates or individual certificateholder has the right to grant or withhold consent for borrower requests or replace the special servicer without cause, and the master servicer and special servicer have authority to make decisions about the loans on their own in the manner they believe is in the best interests of all certificateholders.

## **Conclusion**

While the B-Piece Buyer for a transaction does not make a loan or become party to the servicing agreement, it is a significant presence in a CMBS transaction, from the determination of which loans will be included in the collateral pool to the decisions of whether to approve borrower requests, how to work out a defaulted loan and who the special servicer will be.