PUBLICATION

Bifurcated Note Implementation - Looking Beyond Traditional Risk Metrics to Prevent Borrower Windfall

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In the world of large loan modifications, servicers and borrowers have turned frequently in recent years to the A/B Note structure in situations where the collateral financed by a loan is valued at less than the outstanding balance of the loan. When set up thoughtfully, in most instances both servicer and borrower can benefit from the A/B Note structure. However, there is an underlying risk of inadvertently creating a windfall situation for borrowers under the A/B Note structure when making decisions based upon traditional risk metrics. It is important for servicers to get a handle on the mechanics, benefits, pitfalls, and strategies associated with the structure before considering implementation.

The Mechanics:

Under an A/B Note structure, the original note associated with the loan is bifurcated into a senior A Note and a subordinated B Note.

- **General A Note Characteristics**
  - The principal balance assigned to the A Note from the split of the original note often approximates the current fair market value of the underlying collateral (but the assignment of this balance presents an important decision discussed herein).
  - The A Note obligation usually has a defined maturity date, defined interest rate, defined interest payments, and in some instances monthly principal payments.
- **General B Note Characteristics**
  - The B Note is where the remainder of the original note balance is placed, often after some degree of debt forgiveness on behalf of the lender or trust.
  - The B Note is basically a deferred or contingent obligation. (This brings up important REMIC and Pooling and Servicing Agreement issues, which are not directly addressed herein.)
    - Under some loan modifications the B Note is only payable upon the A Note maturity date or upon the occurrence of a capital event, such as a refinance or sale of the underlying collateral, to the extent such capital event covers the B Note.
    - Under other loan modifications the B Note is only payable to the extent that there is enough excess cash flow in the cash flow waterfall to make the B Note payments before the A Note maturity date.
  - Under the terms of some loan modifications, B Note payments fall behind repayment of new capital contributions made by the borrower (sometimes repaid with interest to the borrower) in the cash flow waterfall.

The Benefits:

- Servicer Benefits:
  - The ability to dodge or at least postpone the hassle and expense of taking over the collateral in foreclosure;

- The opportunity to have a performing A Note instead of the non-performing or underperforming original note;
- The overall deal usually hinges on some range of commitments from borrower to do a combination of the following:
  - make a new capital contribution to the property,
  - pay down the balance of the loan,
  - pay late interest and default charges, and/or
  - bulk up the reserves.

- Borrower Benefits:

  - Often a break on the debt service is given (i.e. - lowered interest rate, forgiveness of part of the debt, extended maturity date, etc.)
  - There is usually an opportunity/requirement for the borrower to reinvest in the property, which could potentially help cash flow at the property and ultimately increase investor returns in the long run.

The Struggle

There is an inherent tug of war between the safety of the A Note and the creation of a windfall for the borrower that plays out in implementing A/B Note structures.

- A Note Safety
  The conventional wisdom is that the higher the LTV ratio, the less borrower equity is at risk, and the riskier the loan is for the lender. The "safer" route from the standpoint of safety of the A Note is to have a lower balance placed on the A Note when the original note is bifurcated, causing the A Note to have a lower LTV. The direct result of this choice in favor of A Note safety, however, is for a higher balance to be placed upon the B Note when the original note is bifurcated, and to set up the potential for a windfall to the borrower.
- The Potential Windfall
  Because the B Note repayment is often an uncertainty hinging on sometimes far-fetched hopes for good future outcomes, such as improved cash flow or a rise in the value of the property, parking a large amount of the original note balance in the B Note can be a gamble. Certainly the A Note would be safer with an LTV below 100% because there would be more borrower equity covering it. But, practically speaking, this set up is a much more favorable deal to the borrower than to the servicer. Because of the lower balance on the A Note, the borrower will pay less in debt service. Because of the contingent nature of the B Note, it may never be repaid. Add to this the possibility that the borrower's capital contribution may be set up to be repaid in the cash flow waterfall before the B Note, and the borrower may even get reimbursed for reinvesting in its own property before ever having to consider paying back the B Note.

The Takeaway

Although metrics typically used for decision-making regarding loans, such as LTV ratios, are useful, servicers should always look beyond such metrics and take care to consider the practical outcome when implementing A/B Notes by:

- Considering placing as much of the principal of the original note as possible on the A Note balance even though the LTV ratio will be elevated. This is especially true when the property cash flow can cover the debt service on an A Note with an aggressive balance; and
- Using caution when negotiating the order of the cash flow waterfall to make sure that any preferred return to the borrower of any capital contribution does not render futile any hopes of recovery of the B Note principal.