Real Estate Finance

Volume 29, Number 3

October 2012

Indemnifying the Issuer: Freddie Mac's CME Program

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One of the few bright spots in today's commercial real estate market is the apartment sector. Apartment building occupancies are up across the country as many Americans postpone home ownership. According to a recent report, an additional 1.5 million Americans recently moved into rental housing, a 4 percent increase in a single year.[1] Rents also are rising with the increased demand for rental housing. As a result of these trends, multifamily property values are up on average about 25 percent since 2010.[2]

At the same time apartment building valuations are on the rise, interest rates are on the decline. Commercial loans on multifamily projects are now available in some cases at fixed rates of less than 3.75 percent for a term of up to 10 years. This combination of rising values and falling interest rates has sharply increased the demand for multifamily lending. Banks, life insurance companies, the Federal Housing Authority (FHA), Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae) have all increased their lending in response to this demand and in response to the improved market fundamentals. In 2011, for instance, Fannie Mae and Freddie Mac saw their first increases in lending since 2007.[3]

This article explores new indemnity provisions found in the documentation for loans originated through Freddie Mac's Capital Markets Execution product (Program). These new indemnity provisions require borrowers and their guarantors to hold Freddie Mac and other parties to the securitization process harmless from losses that may result from untrue statements of material fact made in connection with the securitization of their loans.

Freddie Mac and the parties involved in the commercial mortgage backed security (CMBS) markets have added these new indemnity provisions to their loan documents in direct response to the recent collapse of the CMBS markets and the ensuing litigation. These new indemnity provisions represent an attempt by Freddie Mac and the other players in the CMBS market to pass some of the risk associated with issuing these securities onto the borrowers and their principals.

BACKGROUND

Fannie Mae and Freddie Mac are government-sponsored entities, or GSEs, created in the 1930s and 1970s, respectively, to increase liquidity in the housing markets. In creating Freddie Mac, Congress intended to encourage lending in the residential mortgage market. For instance, Freddie Mac's programs encourage banks to sell their loans into the securitized mortgage markets in expectation that these banks will recycle their capital by making more residential loans. Furthermore, it is hoped that by creating more liquidity in the mortgage market, the GSEs will help keep both the interest rates charged to borrowers and the costs of housing down.

Freddie Mac's primary source of income is charging guaranty fees for mortgage backed securities. In exchange for these fees, Freddie Mac guarantees some, but not all, of the investors in the securities it sponsors. Under the terms of its guaranty, Freddie Mac ensures payment to certain CMBS investors, regardless of whether the underlying loans backing the security can be repaid. Thus, for example, if loans in a CMBS pool sponsored by Freddie Mac go bad, Freddie Mac agrees that it, nonetheless, will pay certain investors, despite the defaulted loans.

Over the years since their creation, Freddie Mac and Fannie Mae began to serve two potentially conflicting interests: (1) their political mission of holding down mortgage rates and (2) their shareholder mission to increase their stocks' value. As the housing market took off, the companies' management fought efforts to increase their capital requirements and opposed regulation that would raise the GSEs' costs and reduce their leverage or profitability.

Unfortunately, shortly after the housing market collapsed in 2007, these GSEs began to experience very large losses. Ultimately, the losses at these companies were so large that they threatened both the US housing and financial markets. In 2008, Freddie Mac and Fannie Mae were placed in conservatorship. Currently, the Federal Housing Finance Agency (FHFA) runs both these GSEs through this conservatorship.

TRYING TO RECOVER

As part of its conservatorship, the FHFA has filed lawsuits against various players in the mortgage backed securities market alleging fraud and misrepresentation. For instance, in *Federal Housing Finance Agency vs. UBS Americas, Inc.*[4] Freddie Mac sued UBS Americas, Inc. claiming, among other things, that the bank misrepresented the creditworthiness of the borrowers in its securitizations and misrepresented the quality of the origination and underwriting practices used to evaluate and approve such loans. In many cases, it is alleged that borrowers and loan originators overstated key underwriting components of their loans, such as the debt service coverage ratios, loan to value ratios and occupancies.

At the same time the FHFA is pursuing claims against parties to the mortgage backed securities market, the agency also is overseeing Freddie Mac's return to the CMBS market. In 2009, Freddie Mac initiated the Program in an effort to revive the CMBS market. Some of the new terms and provisions in the Program's loan documents reflect Freddie Mac's experiences in connection with the collapse of the CMBS market. In particular, Freddie Mac has added indemnity provisions to the Program's loan documents that require borrowers and their guarantors to indemnify and hold harmless third party participants in the CMBS market.

The Program's loans generally are offered to borrowers on a non-recourse basis, meaning that a lender's sole recourse in the event of a borrower default is to foreclose on the property. However, these non-recourse loans typically have carve-outs, or exceptions, which may make the borrower and its guarantors liable for so-called bad boy acts, such as fraud, waste, or bankruptcy. These non-recourse carve-outs can result in serious liability to borrowers and their guarantors as was recently shown in the case *Wells Fargo Bank, N.A. v. Cherryland Mall Limited Partnership*.[5] In *Cherryland*, the court held the borrower's principal and guarantor, David Schostak, liable under the terms of his non-recourse carve-out guaranty of this CMBS's loan due to the borrower's insolvency.

NEW INDEMNITY PROVISIONS IN LOAN DOCUMENTATION

The Program's new indemnity provisions significantly expand a borrower's and guarantor's liability by making them indemnify the lender, issuer of the securities, and their underwriters from any and all losses caused by any "untrue statement of a material fact" or the omission of a "material fact necessary in order to make the statements made, in light of the circumstance under which they were made, not misleading." The Program's loan documents require the borrower and its guarantor to deliver an "indemnification certificate" after the loan closes. Specifically, the borrower and guarantor are required to review the offering documents associated with their loan's securitization for inaccuracies. The borrower and guarantor are then required to certify and indemnify the lender, the CMBS issuer and the underwriters (such as the rating agencies) that the information included in the securitization's disclosure documents (such as the prospectuses, private placement memoranda and offering documents) is true and correct. The indemnification in the Program's loan documents even extends to paying any legal fees or other expenses incurred in investigating or defending any securities liabilities caused by a material misstatement of fact.

This new indemnity provision adds significant burdens and risks to borrowers and their guarantors. For instance, once a borrower closes on its commercial loan, it does not typically expect to review and approve the offering prospectus put out by its lender in trying to re-sell the loan in the mortgage backed securities market. More importantly, the provisions place the burden on the borrower to review these documents and certify that the information provided in connection with the loan's underwriting was true and correct.

Guarantors, in particular, face significant new risks as a result of this indemnity provision. Many guarantors are not familiar with a borrower's day-to-day operations and cannot reasonably be expected to know whether much of the information provided in connection with the loan's origination are true. Unfortunately, most guarantors who execute the non-recourse carve-out guarantees associated with CMBS loans believe that the guarantees cover only very limited "bad boy" acts and would be surprised to learn that by signing these guarantees they are also guaranteeing the accuracy of the information used to securitize the borrower's loan.

Freddie Mac has posted the Program's form loan documents on its Web site at *HUwww.freddiemac.com/multifamily/cme.htmlUH*. The indemnity provision discussed in this article is found in Section 10.02 of the form loan agreement and incorporated into the form of guaranty. Because the Program currently represents an increasing percentage of the multifamily loans originated in the United States, borrowers and guarantors should carefully consider their indemnification obligations and the affiliated risks associated with participating in the Program.

NOTES

1. "U.S. Economic and Housing Market Outlook," *Morning Star*, June, 19, 2012.
2. *Id*.
3. Fannie Mae, Economics and Mortgage Market Analysis, March 2012.
4. *Federal Housing Finance Agency v. UBS Americas, Inc.,* No. 11CIV5201, 2012 WL 1570856 (S.D.N.Y. May 4, 2012).
5. Wells Fargo Bank, N.A. v. Cherryland Mall Limited Partnership, 812 N.W.2d 799 (2011).