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# IMPOSSIBLE, IMPRACTICABLE, OR JUST EXPENSIVE?

## ALLOCATION OF EXPENSE OF ANCILLARY RISK IN THE CMBS MARKET

GEORGETTE CHAPMAN POINDEXTER\*

### INTRODUCTION

Suppose that A and B enter into a loan agreement wherein A promises to repay principal and interest to B at specified intervals secured by a first lien on A's shopping mall. In making the loan to A, B assessed several risk factors culminating in calculating the default risk that A may not repay the entire loan amount.<sup>1</sup> In analyzing A's default risk profile, B will not only look to A's creditworthiness but also to other factors that may impede or preclude full performance by A. In response B may require covenants and promises by A to address these factors. For example, B will require that A purchase property insurance that will compensate B in the event of casualty. B may require a covenant that A maintain adequate cash flow to cover the debt service. However, despite the most thorough due diligence on B's part, an unexpected event can occur which shakes the underlying covenants that composed A's risk profile. Suddenly A's loan is much riskier and, by corollary, under-priced to compensate B for the new risk.

Should B be entitled to readjust A's risk profile and demand a higher return thus shifting the cost of readjustment to A? In other

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\* Professor of Real Estate, Wharton School, Professor of Law, University of Pennsylvania Law School. This article is an extension of a paper presented May, 2002 at the Robert Kratovil Memorial Lecture in Real Estate Law at John Marshall Law School. Thanks to Stuart Ebby, Rick Jones, Donald Siskind, Todd Sinai, Peter Linneman, Chris Mayer and Michael Knoll for comments and insights on a previous draft. Of course, remaining errors belong to me.

1. Other risks include interest rate risk (which affected whether A might prepay the loan if market interest rates dropped), and informational risk (where there is asymmetry of information between the parties that may lead to an uneven bargaining situation). Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Loan Default in the Era of Securitization*, 50 EMORY L. J. 519, 543 (2001).

words, who assumes the risk and bears the burden of changed circumstances of A's default profile? To take the analysis one step further, if A refuses to perform the covenants and will not take on the cost of the additional risk, should B be permitted to declare a default or is A excused from the risk without threat of default? From a contract theory perspective the answer will turn on an analysis of the unexpected event and how/if A and B implicitly or explicitly calculated the probability of the unexpected event. To restore A's pre-event risk profile will it be impossible, impracticable or just expensive?

This commentary will address the implications of event risk. No one can accurately predict all future risks, particularly those outside, or ancillary, to the real estate market. The purpose of this discussion is to begin to formulate a legal structure that will allow parties to address unforeseen ancillary risk and reflect legal treatment of such risk in their pricing.

#### I. BACKGROUND.

In the single lender/borrower scenario (referred to as a whole loan), the risk profile of the borrower is private and individualistic.<sup>2</sup> However, when we move into the open market of Commercial Mortgage Backed Securities (CMBS) the risk profile is not only public, but also standardized. The hallmark of the CMBS market is its ability to match risk with return in pricing mortgage debt. In contrast with the whole loan market, CMBS offers investors the insight (and protection) of default risk assessment that is correlated to both the strength of the underlying mortgage pool and the subordination level of a particular class of securities. The higher the rating on a class, the less likely it will suffer a default but the lower the yield. The lower the rating the more likely the reverse is true. Rating agencies such as Moody's, Standard and Poor's, and Fitch assess the likelihood of ultimate receipt of principal and the timely receipt of interest: *i.e.*, it is an assessment default risk.<sup>3</sup> Their ratings do not reflect other risks such as interest rate risk, event risks, or informational risks.<sup>4</sup>

Since September 11, 2001 the impact of event risk has had a new effect on default likelihood considerations. These events are not real estate-related risks (economic downturns, over-leveraged borrowers, etc.). In fact, they occur outside the sphere of traditional real estate-related risks. The term ancillary risk or default, as used in this commentary, does not refer to defaults caused by the under performing loan collateral: the real estate

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2. *Id.* at 541-42.

3. *Id.* at 543.

4. *Id.*

asset. Rather it refers to defaults caused by non-real estate related events. The U.S. District Court's<sup>5</sup> decision that World Trade Center leaseholder Larry Silverstein could only collect from some carriers for one insured occurrence,<sup>6</sup> brings into sharp focus the possibility of ancillary default and the power of ancillary events to bring about delinquency and default in commercial real estate mortgages. Instead of collecting for two insured events, Mr. Silverstein stands to collect only for one event even though both towers were destroyed.<sup>7</sup> This fifty percent reduction in available insurance proceeds was most certainly not anticipated in assessing the likelihood of default because Mr. Silverstein cannot reconstruct the Towers.

Ancillary default risk, as used herein, is more than event risk, though. It is a risk that has industry wide, as opposed to property specific, implications and whose existence was wholly unanticipated in scope and magnitude.

This article uses the aftermath of 9/11 as an example. It focuses on two consequences: (1) the unforeseen plunge in business travel after September 11, 2001 which threatens the net operating income (and hence debt service coverage ratio covenants) in hotel loans; and (2) the new terrorism insurance requirements (including forced placement) imposed on borrowers at the renewal of their property and casualty insurance. This commentary proposes contract interpretation that will promote transparency of the possibility of event risk and recognition of ancillary default risk to effectuate a more robust rating/pricing scheme.

Furthermore, this article will focus exclusively on so-called "non-monetary default," *i.e.* defaults other than nonpayment of monthly debt service.<sup>8</sup> This is not to imply that ancillary default risks such as natural disasters and war cannot result in the non-payment of debt service. Obviously they can. Rather, this focus on non-monetary default allows exploration of the concept of changed circumstances such that, if revealed *ex ante* (instead of *ex post*), would have resulted in a different risk profile of the transaction.

As stated in the author's previous work, the CMBS market could not efficiently function without the participation of the rating agencies.<sup>9</sup> Rating agencies model default risk and inform

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5. *SR. Int'l Bus. Ins. Co. Ltd. v. World Trade Ctr. Props.*, 222 F. Supp. 2d 385 (S.D.N.Y. 2002).

6. *Id.* at 399.

7. *Id.* The loan documents in this transaction contained a covenant to rebuild. *Id.*

8. See *Glossary*, available at <http://rdinit.usda.gov/regs/handbook/w6gloss.pdf> (defining non monetary default as a default that does not involve the payment of money).

9. See Poindexter, *supra* note 1, at 543 (describing how the CMBS market reflects risk).

prospective investors of the relative risk of non-payment.<sup>10</sup> This article strives to take this attempt at risk transparency one step further to sharpen the analysis of default risk of the underlying loans that translate into the default profile of the CMBS pool. Instead of reacting after the fact to an ancillary risk, we can interpret the underlying legal documents in a constructive manner for reflecting non-asset based default risk. Rating, and hence pricing, relies on full information on the part of the rating agency. The obvious difficulty with anticipating ancillary events is that by definition they are unexpected and unanticipated. Further complicating this analysis is the tendency of hindsight bias to overestimate the likelihood and the foreseeability of events such as the 9/11 tragedy. However, more legal structure as part of the default risk analysis may be highly beneficial. Such structure sharpens the rating agencies' gaze and provides more complete information to the investors and other CMBS market participants.

## II. OVERVIEW OF THE CMBS MARKET

The CMBS market is a secondary market in which commercial mortgages are pooled.<sup>11</sup> Investors buy certificates collateralized by the income stream from the pool of mortgages.<sup>12</sup> The pools are rated by rating agencies that assess the likelihood of default based on subordination levels.<sup>13</sup> The higher the rating, the more underlying subordination and the less likely the investor will suffer a loss through default.<sup>14</sup> As of the first quarter of 2002, private label issuances of securitized debt (*i.e.* not GSE or federal related agencies) came close to \$300 billion.<sup>15</sup>

Defaults and delinquencies have begun to up-tick in the securitized pools.<sup>16</sup> One rating agency reports that there were more than one hundred and thirty-one defaults in 2000—more than

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10. In fact several rating agencies have begun to integrate terrorism risk into their rating model. *See generally* Moody's Investors Service, *CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate*, in *STRUCTURED FINANCE: SPECIAL REPORT 1* (Mar. 1, 2002).

11. *See* Poindexter, *supra* note 1, at 520 (stating that the pooling of commercial mortgage loans generates tradable debt securities backed by the pool of loans).

12. *Id.*

13. *See id.* at 521 (explaining the concept of subordinated rolling equity).

14. *See id.* at 532 (discussing the structure of the CMBS market).

15. Federal Reserve Board of Governors, *Flow of Funds Accounts*, Mortgage Banker's Ass'n of America, at [http://www.mbaa.org/cref/data/02/cmdo\\_q102.html](http://www.mbaa.org/cref/data/02/cmdo_q102.html) (last visited May 4, 2003).

16. However, defaults and delinquencies in the CMBS market still pale in comparison to massive default/delinquency scenario of the real estate depression of the early 1990s.

double the 1999 defaults.<sup>17</sup> In 2001, fifty-six percent of the deal population had at least one loan default since issuance, as compared to thirty-six percent in 1999.<sup>18</sup> Analysts attribute this increase to seasoning of conduit loans, expansion of the loan population and weakening economics in certain property sectors.<sup>19</sup> Whereas worsening economic conditions drove defaults prior to September 11, 2001, the terrorist attacks ratcheted up the specter of default to a new level.<sup>20</sup> For example, before 9/11 the hotel sector had a default rate of 2.61 percent.<sup>21</sup> The abrupt slow-down in business travel exacerbated an already bleak situation. After September 11, analysts peg the default rate in the hotel sector at 6.30 percent.<sup>22</sup>

Terrorism insurance is another new wrinkle in the CMBS market. In response to 9/11, CMBS servicers have begun to require purchase of this insurance product, which historically had been bundled with property insurance. This mandate produced several consequences. First, a lack of insurance product threatened to put loans into technical default. Second, even if the product was available, its cost was prohibitive. Third, if borrowers refuse to purchase the policy it can be force-placed by the servicers. This dries up the cash flow from the pool, threatens the ratings, and applies upward pressure on the yields of the securities of the transaction. The spread between the yield on CMBS and comparable treasuries widened as much as approximately thirty basis points since 9/11.<sup>23</sup>

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17. Fitch Ratings, *Perfect to a Default: 2001 CMBS Conduit Loan Default Study*, STRUCTURED FINANCE: COMMERCIAL MORTGAGE SPECIAL REPORT, May 7, 2001 at 1, available at [http://www.fitchratings.com/corporate/reports/report.cfm?rpt\\_id=126128](http://www.fitchratings.com/corporate/reports/report.cfm?rpt_id=126128) (last visited May 4, 2003).

18. *Id.* at 2.

19. *Id.*

20. *Id.* at 1.

21. *Id.* To put this in context, however, in 1992 the delinquency rate in the lodging sector was 15.05 percent. *Id.* This high delinquency rate was primarily due to profligate financing rather than collapse in property operating performance. *Id.* See also *CMBS Quarterly Insights: The Shape of CMBS Since Sept. 11*, STRUCTURED FINANCE, Oct. 23, 2001 (noting that despite the enormous tragedy on September 11, no defaults were expected which would be due to the events at the World Trade Center).

22. Fitch Ratings, *2002 CMBS Conduit Loan Default Study*, STRUCTURED FINANCE: COMMERCIAL MORTGAGE SPECIAL REPORT, Aug. 14, 2002, at 5, available at [http://www.fitchratings.com/corporate/reports/report.cfm?rpt\\_id=152030](http://www.fitchratings.com/corporate/reports/report.cfm?rpt_id=152030) (last visited May 4, 2003).

23. Robert Burgess, *Terror Coverage Cost Holds Up Deals*, CHI. SUN-TIMES, Mar. 3, 2002, at 29.

### III. ANCILLARY DEFAULT RISK

The events of 9/11 and the subsequent economic and political changes were not anticipated in assessing the risk in the CMBS market. However, these events threatened loan solvency in a similar manner as the overbuilding and high vacancy rates of the last recession. In fact, today's CMBS market has moved from a favorable B stress environment to a more stressful BB environment.<sup>24</sup> The difference between the two stress producing environments is that overbuilding (real estate/economic related risk) could have (should have) been modeled into the lender's underwriting and default risk analysis. The events of 9/11 provide an excellent example of risk that could not have been anticipated. During the contract negotiations between lender and borrower, neither party contracted to undertake the risk so the question posed is who should bear the risk now?

To analyze this issue we can look to contract theory—specifically the theory of impracticability. Unlike a traditional analysis, however, this article is not so interested in contract damages in light of one party's non-performance. Rather, this commentary focuses on how and if unexpected non-real estate related risk can be addressed contractually. Ancillary default risk from non-real estate related events impacts a borrower's default profile and thus, for purposes of transparency, should be modeled in the same fashion as real estate risk.

Before discussing how to incorporate the threat of ancillary default in the legal documentation underlying a CMBS transaction, it would be useful to expand on how the events of 9/11 impacted the CMBS market. Illustrative of this impact are the deepening crisis in the hotel sector and the requirement to purchase terrorism insurance.

#### A. Hotel Sector

Even before 9/11, the hotel sector showed signs of struggle due to a softening economy.<sup>25</sup> After 9/11, occupancy levels plummeted.<sup>26</sup> For instance, Moody's cut MGM Mirage and Park

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24. Fitch Ratings, *Perfect to a Default*, *supra* note 17, at 1.

25. Cracks in the sector were evident in 1999 when both Duff & Phelps and S&P downgraded Asset Securitization Corp.'s 1997-MD VII transaction based on a continuing decline in the performance of Fairfield Inn loans. See *DCR Places Asset Securitization Corporation, Series 1997-MD VII on Rating Watch-Down*, PR NEWswire, Sept. 9, 1999; Adam Tempkin, *Is the Hotel Sector Finally Stabilizing?*, Mortgage Backed Securities Letter, July 31, 2000, at 1. S & P issued a further downgrade in 2001. *CMBS Quarterly Insights: The Shape of CMBS Since Sept. 11*, *supra* note 21.

26. See Christina Binkley, *Empty Rooms: U.S. Hotels Struggle to Cope with Drop in Guests Since Attack*, WALL ST. J., Sept. 28, 2001, at A1 (describing

Place Entertainment Corp. to below investment grade.<sup>27</sup> Fitch cut Starwood Hotels & Resorts Worldwide and Hilton Hotel Corp to junk status citing the tough economic outlook in the hotel industry.<sup>28</sup> As of September 2002, hotel sector loans that were securitized in the CMBS market had a delinquency rate of 4.61 percent—far in excess of retail (2.07 percent), multifamily (1.12 percent), and office (0.69 percent) rates.<sup>29</sup> In light of the impact of 9/11 on their industry, some hotel executives even went to Washington in search of tax breaks and other relief,<sup>30</sup> though no such relief was forthcoming.

The events in the lodging sector provide one bookend to our discussion of whether ancillary risk can be addressed in drafting loan documents. While 9/11 certainly had a negative impact on the default profile of the pools in the lodging sector, the change was of degree, not of kind. The risk of low occupancy and hence low revenue is a constituent part of the default risk profile. What was unanticipated was not that there might be a chance of decreased occupancy. Rather, the unanticipated factor was that occupancy would plummet so far, so quickly. The first boundary parameter to the analysis, therefore, is that *an unexpected event that exacerbates existing default risk is not an ancillary risk.*

### B. Terrorism Insurance

Most standard mortgage documentation obligates the borrower to purchase insurance “as the lender may reasonably require.” Prior to 9/11, insurance against terrorism was wrapped into a borrower’s all risk insurance policy.<sup>31</sup> However, for example, when the insurance policy for Mall of America in Minnesota came up for renewal in January 2002 the owner, Simon Property Trust, provided a new insurance policy that explicitly excluded coverage for loss or damage due to terrorism.<sup>32</sup> The loan servicer, GMAC,

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how two weeks after Sept. 11, occupancy down 38.4 percent).

27. Christina Binkley, *Moody’s Cuts Back Ratings on MGM and Park Place*, WALL ST. J., Jan. 15, 2001, at A2.

28. *Id.*

29. *Loan Performance by Property Type Sept., 2002*, available at <http://www.trepp.com> (last visited May 4, 2003). It should be noted that in a historical context these “high” lodging sector delinquencies are low. *Id.* In 1992 the delinquency rate in this sector averaged 15.05 percent. *Id.* *CMBS Quarterly Insights: The Shape of CMBS Since Sept. 11*, *supra* note 21.

30. See Binkley, *supra* note 26, at A1 (discussing the hotel industry’s attempt to get governmental support).

31. See John B. Levy, *Policy Dispute: GMAC, Mall Owner Battle Over Terror Coverage*, BARRONS, Mar. 4, 2002, at 33 (discussing increased commercial mortgage delinquencies and the conflict between one Simon property group and GMAC commercial mortgage).

32. *Id.*



insisted that the property be insured for losses due to terrorism.<sup>33</sup> GMAC threatened to force place<sup>34</sup> an insurance policy covering terrorism at a cost of 750,000 dollars for 100 Million dollars in coverage.<sup>35</sup> Simon obtained a temporary restraining order on the purchase.<sup>36</sup>

Similar noteworthy battles were played out between lenders and borrowers across the country.<sup>37</sup> The cost and availability of separate terrorism insurance was affecting the financiability of urban skyscrapers and large malls considered to be at risk of attack as well as midrise office buildings far from the any likely terrorist activity.<sup>38</sup> Some commentators blamed the sluggish beginning<sup>39</sup> and widening spreads<sup>40</sup> over treasuries of the CMBS market of 2002 on the uncertainty over terrorism insurance.

Lack of terrorism insurance dulled the real estate loan market.<sup>41</sup> As a result of a scramble to obtain an insurance product that was never previously required, lenders postponed or canceled billions in pending new commercial mortgage loans.<sup>42</sup> From the insurance companies' perspective, the economic difficulty in pricing and providing terrorism insurance is easily understood.<sup>43</sup> Abrupt changes in expectations forced risk managers to exclude and limit coverage until they could reassess the degree of risk involved and obtain reinsurance.<sup>44</sup> In the interim, however,

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33. *Id.*

34. The servicer purchases the policy and then bills the borrower for the premium.

35. *Id.*

36. *Id.*

37. See Gregg Loubier and Jason B. Aro, *Insuring the Risks of Terror*, LOS ANGELES LAWYER, Sept. 2002, at 19 available at [http://www.allenmatkins.com/events/publications/los\\_ange.pdf](http://www.allenmatkins.com/events/publications/los_ange.pdf) (last visited May 12, 2003) (noting as an example, the Conde Nast Building in New York and Opryland Resort and Convention Center in Tennessee).

38. *Id.* at 20.

39. See John B. Levy, *Terror's Modest Price: Loan Market takes insurance lack in stride*, BARRON'S, Feb. 4, 2002, at 33 (describing market uncertainty as a factor in limiting market activity).

40. Burgess, *supra* note 23, at 29.

41. See Xenia Jowyk, *Terror Insurance Drag on Real Estate Still Climbing: Over \$15.5 Billion of Projects in 17 States Now Affected*, THE REAL ESTATE ROUNDTABLE: NEWS RELEASES, Sept. 19, 2002, (indicating an increase in cancellation of projects), available at [http://www.rer.org/media/newsreleases/pr\\_091902.cfm](http://www.rer.org/media/newsreleases/pr_091902.cfm) (last visited May 12, 2003).

42. See Dawn Kopecki, *US CMBS Market Hit by Terrorism Insurance Costs, Canceled Loans*, DOW JONES INT'L NEWS, Apr. 18, 2002 (citing cancellation of more than seven billion dollars in commercial mortgages due to terrorism insurance costs). See also Jowyk, *supra* note 41 (citing over 15.5 billion dollars worth of real estate projects in seventeen states stalled or cancelled due to scarcity of terrorism insurance).

43. Jowyk, *supra* note 41.

44. Jo Ann Marzullo, *Dealing with Insurance Exclusions in Response to*

existing borrowers were left uninsured and in technical default or faced huge premiums. Furthermore, rating agencies began to warn of possible downgrades signaling a change in default risk for lack of terrorism insurance.<sup>45</sup> In fact, Moody's and Fitch downgraded billion of dollars in single asset CMBS due to terrorism insurance concerns.<sup>46</sup>

Just as in the hotel sector, some industry players called for intervention by the federal government to reinsure terrorism policies.<sup>47</sup> In contrast to the hotel pleas, bills were introduced in

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*Terrorism*, 16 PROB. & PROP. 37, 38 (Sept./Oct. 2002). Large losses, such as terrorist attacks, create problems in the insurance market because of lack of independence. *Id.* Decomposing the risk (*i.e.* separating terrorism from the all risk policy) leaves the undiversifiable risk with the policy holders. *Id.* For an explanation of this risk partitioning see generally Karl Borch, *Equilibrium in a Reinsurance Market*, 30 ECONOMETRICA 424, (1962) (describing that the presence of uncertainty will result in less than efficient reinsurance markets); Georges Dionne & Neil Doherty, *Insurance with Undiversifiable Risk: Contract Structure and Organizational Form of Insurance Firms*, 6 J. OF RISK AND UNCERTAINTY 187, 199 (1993) (describing that insurance contracts will be separated into contracts where risk can be pooled and contracts where risk cannot be pooled).

45. See Julie Haviv, *Moody's Warns Commercial Mortgages without Terror Insurance*, DOW JONES INT'L NEWS, May 3, 2002 (noting that without Congressional action, the CMBS would face downgrades); Dawn Kopecki, *US CMBS Market Hit by Terrorism Insurance Costs, Canceled Loans*, DOW JONES INT'L, Apr. 18, 2002 (describing the weakness of CMBS market); *Policy Dispute: GMAC, Mall Owner Battle Over Terror Coverage*, BARRON'S, Mar. 4, 2002, at 33 (describing that the largest issue facing the mortgage industry is the lack of terrorism insurance). In light of the uncertainty surrounding who would be required to purchase terrorism insurance, Moody's created a matrix assessing the likelihood of requiring terrorism insurance from a ratings perspective. *Id.* See Daniel B. Rubock & Tad Phillips, *CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate, Structured Finance: Special Report*, Mar. 1, 2002, at 3 (indicating that insurances had difficulties with putting premiums on terrorism risks).

46. Janet Morrissey, *REITs Hail Passage of Terrorism Insurance Legislation*, DOW JONES BUS. NEWS, Nov. 20, 2002.

47. The most notable players were the Mortgage Bankers Association and the American Bar Association. See *More than \$8 Billion in Commercial Property Deals Killed, Delayed or Changed Due to Terrorism Insurance Issues*, NEWS RELEASE (Mortgage Bankers Ass'n of America) July 15, 2002, at 5, available at <http://www.mbaa.org/news/2002/pr0715a.html> (last visited May 12, 2003) (indicating that the Mortgage Bankers Association believes that the federal government should pay for the initial losses for reinsurance); Martha Neil, *Terrorism Insurance Bailout Stalls in Congress*, 17 A.B.A. J. E-REPORT 3 (May 3, 2002). Such public reinsurance is not a novel concept. *Id.* In the United Kingdom the Pool Reinsurance ("Pool Re") was established in 1993. *Id.* See James G. Rizzo, *Tragedy's Aftermath: The Impact of 9/11 on the Insurance Industry*, 46 BOSTON B. J. 10, 13 (Jan./Feb. 2002). In Israel, there are two government backed insurance programs for terrorism risk. *Id.* However, there has been opposition to such governmental intervention. See Dawn Kopecki and Julie Haviv, *Consumer Group Says Broad Terror Insurance Bill*

both houses that in differing parameters, provided a governmental backstop to loss due to terrorism.<sup>48</sup> The Terrorism Risk Insurance Act of 2002 was signed by President George W. Bush in November 2002.<sup>49</sup> This program institutes temporary government/private sector risk sharing of catastrophic loss due to international terrorism and provides mandatory availability of insurance product.<sup>50</sup>

Even though terrorism existed in the United States prior to 9/11 (*e.g.* the bombing of the Federal office building in Oklahoma City in 1995, or even the first bombing of the World Trade Center in 1993), the purchase of terrorism insurance was certainly not even discussed in loan negotiations before 9/11. However after 9/11, loans without such insurance faced either downgrades by rating agencies or exponential leaps in insurance premium costs that threatened cash flow and even solvency.<sup>51</sup> Our other bookend boundary, then, is that *an ancillary risk must be one that introduces an entirely new risk to the default profile that did not exist at the time the loan contract was drafted.*

#### IV. IMPOSSIBLE OR EXPENSIVE?

Simply denominating the ancillary risk as “new,” however, only begins the analysis. The ancillary risk that threatens a borrowers’ default profile cannot have been within contemplation of the parties at the time of contracting. Otherwise, it would have been modeled by the rating agencies. The trick is to cut a dividing line between performance that an ancillary event made more

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*Unnecessary*, DOW JONES INT’L NEWS, Aug. 22, 2002 (arguing that the federal government does not need to support a backup of terrorism insurance claims).

48. *Id.*

49. Terrorism Risk Insurance Act of 2002, PUB. L. NO. 107-297, § 101, 116 STAT. 2322 (Nov. 26, 2002). Under the new law, insurance companies would be responsible for paying a deductible increasing from seven percent of premiums in 2003 to fifteen percent of premiums in 2005. *Id.* § 102. The federal government will pay for ninety percent of claims above the deductible. *Id.* § 103. Losses paid by the federal government are capped at 100 billion dollars per year. *Id.* The real estate industry applauded this measure. *Id.* See also Standard & Poor’s, *REITs likely to Benefit from Passage of Terrorism Risk Insurance Act*, Nov. 20, 2002, available at <http://news.cnet.com/investor/newsitem/0-9900-1028-20688004-0.html> (last visited May 12, 2003) (indicating that REITs will benefit from the Terrorism Risk Insurance Act); Joseph B. Treaster, *Industries Welcome US Aid on Terror Insurance*, N.Y. TIMES, Nov. 21, 2002, at C5. However, rating agencies were less enthusiastic. See Standard & Poor’s, *Little Ratings Cheer for Insurers*, Nov. 26, 2002, available at <http://www.insurancejournal.com/news/newswire/national/2002/11/26/24625.htm> (last visited May 12, 2003) (stating that “[f]rom a rating perspective the positive effects are few”).

50. See *supra* note 47 and accompanying text.

51. See *supra* notes 42-46 and accompanying text.

expensive than originally envisioned and performance made impossible or commercially impracticable by an ancillary event. By analogy, the legal theory undergirding ancillary risk is akin to theories of contractual impossibility/impracticability.<sup>52</sup> By mining the rich and developed law of contract impossibility and impracticability, we can refine the boundaries of what should and should not be defined as ancillary risk.<sup>53</sup> Furthermore, this body of law gives guidance as to possible remedies for who should bear the expense of ancillary risk should one occur.<sup>54</sup>

#### A. What is Impossibility/Impracticability?

A contracting party is not relieved from his/her obligations under the contract simply because performance becomes more burdensome or less desirable.<sup>55</sup> In fact, contract performance is tantamount to strict liability under the theory of *pacta sunt servanda*.<sup>56</sup> There are times, though, where the court will excuse non-performance if such performance is impossible.<sup>57</sup> Moreover, the notion of impossible has been widened to encompass “commercially impracticable” when performance can only be done at excessive and unreasonable cost.<sup>58</sup> The defense of impracticability shields a contracting party if events after contract

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52. See generally John D. Wladis, *Impracticability as Risk Allocation: The Effect of Changed Circumstances Upon Contract Obligations for the Sale of Goods*, 22 GA. L. REV. 503 (1988) (describing the relation of risk to the commercial impracticability defense).

53. *Id.*

54. *Id.*

55. See *Beebe v. Johnson*, 19 Wend. 500, 500 (N.Y. Sup. Ct. 1838) (stating that the difficulty or improbability of accomplishing a task would not excuse a party from performing under the contract). See also *Ellis Gray Mill Co. v. Sheppard*, 222 S.W.2d 742, 748 (Mo. 1949) (stating that unforeseen difficulties will not excuse a party from performing under the contract).

56. Latin for “agreements must be kept.” BLACK’S LAW DICTIONARY 1133 (7th ed. 1999).

57. See, e.g., *Spalding v. Rosa*, 71 N.Y. 40 (N.Y. 1877) (excusing performance for an ill opera star); *Chicago, M. & St. P. Ry. Co. v. Hoyt*, 149 U.S. 1 (1893) (excusing performance in a situation that involved leases of grain elevators).

58. *Mineral Park Land Co. v. Howard*, 156 P. 458 (Cal. 1916). See also Sheldon Halpern, *Application of the Doctrine of Commercial Impracticability*, 135 U. PA. L. REV. 1123, 1133 (1987) (stating that “[w]ith these few simple words, physical impossibility had become commercial impracticability”). For a complete review of the history of the evolution of the doctrine of impracticability see Leon E. Trakman, *Winner Take Some: Loss Sharing and Commercial Impracticability*, 69 MINN. L. REV. 471 (1985). Care should be taken here though. *Id.* Simply because the cost of performance increases does not satisfy the requirement of commercial impracticability. *Id.*; *Am. Trading & Prod. Corp. v. Shell Int’l Marine Ltd.* 453 F.2d 939, 942 (2d Cir. 1972).

formation dramatically increase the cost of performance.<sup>59</sup> The Restatement (Second) of Contracts provides relief for impracticability in section 261:

Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.<sup>60</sup>

Therefore, if a contract term is deemed commercially impracticable, the party is excused from performance of that obligation without threat of default.<sup>61</sup>

There is an underlying supposition here that must be highlighted. The non-occurrence of the event must have been a basic assumption at the time of contracting.<sup>62</sup> In other words, the occurrence of the event that caused the dramatic increase in cost of performance must not have been contemplated at the time of contracting.<sup>63</sup> Otherwise, the obligor implicitly takes the risk of increased cost of performance.<sup>64</sup> This stream of theoretical analysis dovetails well with the foundation laid above for defining ancillary risk and default. As previously stated, an ancillary risk is unanticipated and constitutes an entirely new dimension to the default profile.<sup>65</sup>

Unforeseeability of ancillary risk thus becomes crucial. It stands to reason that if an event is foreseeable, performance after the event cannot be deemed impracticable. Events that are foreseeable can and should be insured against by the contracting party whose performance would be rendered more expensive.<sup>66</sup>

For example, take a contract where A contracts to supply B

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59. Susan Wuorinen, *Northern Indian Public Service Company v. Carbon County Coal Company: Risk Assumption in Claims of Impossibility, Impracticability and Frustration*, 50 OHIO ST. L.J. 163 (1989).

60. RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981).

61. *Id.*

62. *See id.* § 261 cmt. b (describing the assumption made in order for the defense to be used).

63. *Id.*

64. *Transatlantic Fin. Corp. v. U.S.*, 363 F.2d 312, 315 (D.C. Cir. 1966); *United States v. Winstar* 518 U.S. 839, 906 (1996). *See also* John Eloffson, *The Dilemma of Changed Circumstances in Contract Law: An Analysis of the Foreseeability and Superior Risk Bearer Tests*, 30 COLUM. J.L. & SOC. PROBS. 1, 4 (1996) (noting that "contracts implicitly allocate most risks of performance to the promisor").

65. *See supra* notes 55 and 58 and accompanying text.

66. *See Barbarossa & Sons, Inc. v Iten Chevrolet, Inc.*, 256 N.W.2d 655, 659 (Minn. 1978) (asking "whether the risk . . . was so unusual or unforeseen and would have such severe consequences that to require performance" would produce an unbargained for advantage).

next year with 100 widgets for 100 dollars. In this scenario, A bears the risk of an increase in price of widgets. If A is concerned about the fluctuating widget prices, she can hedge or otherwise buy price insurance. However, a rise in widget prices will not relieve A from delivering at the agreed upon 100 dollars because a rise in widget prices is foreseeable at the time of contracting.<sup>67</sup>

The issue becomes clearer if we situate foreseeability in the context of ancillary risk of the events of 9/11. In the hotel industry, the aftermath of 9/11 produced a sharp drop-off in occupancy.<sup>68</sup> Therefore, the relevant question is whether occupancy fluctuations were in contemplation of the parties when they entered into the mortgage contract? Certainly. Just as in the widget example, the answer to this question forces the conclusion that non-performance cannot be excused on the basis of impracticability.<sup>69</sup>

On the other hand, after 9/11 lenders began to require borrowers to incur insurance premiums exponentially higher because of terrorism coverage.<sup>70</sup> Was such an increase in contemplation of the parties at the time of contracting? Probably not. This is especially true in light of the fact that terrorism insurance did not exist as a U.S. insurance product prior to 9/11, despite previous acts of terrorism on U.S. soil.<sup>71</sup> Therefore, the definition of ancillary risk must be refined to provide that the mere event, in this case the terrorism, is not the causative root of impracticability. Rather, it is the aftermath of the event that must be unforeseen and not in contemplation of the parties to the contract.

## V. EX POST RULES GUIDING EX ANTE NEGOTIATION

The maddening difficulty in this exercise is applying boundaries defined post contract formation to negotiations that, by definition, are before formation of the contract.<sup>72</sup> A default rule of

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67. See Elofson, *supra*, note 64 at 1.

68. See *supra* note 26 and accompanying text.

69. See *supra* notes 44 and 55 and accompanying text.

70. See *supra* notes 10, 39, and 42 and accompanying text.

71. See William C. Thompson, Jr., *One Year Later: The Effects of 9/11 on Commercial Insurance Rates and Availability in New York City*, N.Y. City Comptroller's Office, Nov. 13, 2002, available at <http://comptroller.nyc.gov/bureaus/opm/reports/11-13-02-insurance-report.pdf> (last visited May 12, 2003) (releasing the results of a survey demonstrating a dramatic increase in commercial insurance premiums and a significant decline in the availability of insurance since 9/11). Unlike war, terrorism was not excluded from the all risk coverage. *Id.* It was included in property and business interruption policies and not a separately rated exposure. *Id.*

72. See generally Alan O. Sykes, *The doctrine of commercial impracticability in a second-best world*, 19 J. LEGAL STUD. 43 (1990)

contract interpretation will guide the modeling of risk.<sup>73</sup> The struggle in promoting a default rule for contract interpretation that resolves the ambiguity of ancillary risk lies in determining who bears the burden of the ramifications of a new event, unforeseen and, hence, unanticipated by the parties at the time of contracting. To begin to unravel this piece of the puzzle, the preliminary inquiry should focus on what is the goal of the default rule: ex ante certainty or ex post efficiency.

Ex ante certainty relies on the premise that contracting parties only undertake risk contemplated by the contract.<sup>74</sup> In the case of an unforeseen event that gives rise to commercial impracticability, the non-breaching party would not be entitled to expectation damages based on breach of contract but rather only to restitution or reliance damages. This approach does not examine which of the parties would be better situated to absorb a loss from an unforeseen event; it simply excuses performance, thus promoting a certainty of result.

On the other hand, there is the notion that loss caused by unforeseeable events should be *shared* by the parties.<sup>75</sup> Some scholars advocate sacrificing certainty in favor of market efficiency and fairness.<sup>76</sup> Efficiency of result replaces efficiency of prediction.<sup>77</sup> This approach forces a two-step process. First, the scenario must fit into the framework of commercial impracticability.<sup>78</sup> The next task is to determine the better risk-bearer.<sup>79</sup> Which party is better able to absorb the loss? This is such a mind-boggling task, however, that according to one scholar,

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(discussing the difficulty courts have in creating rules that evaluate ex-ante decisions).

73. *Id.*

74. *Id.*

75. See Trakman, *supra* note 35, at 485 (noting that shared responsibility requires both parties to bear part of the loss).

76. See, e.g., Robert E. Scott, *The Case For Formalism In Relational Contract*, 94 NW. U. L. REV. 847, 858 (2000) (noting that “[i]f there are to be tradeoffs, why not trade off the chimera of ex ante certainty in favor of ex post efficiency (or fairness)”); K.M. Sharma, *From “Sanctity” To “Fairness”: An Uneasy Transaction In The Law Of Contracts?* 18 N.Y.L. SCH. J. INT’L & COMP. L. 95, 177 n. 318 (noting that “[i]t is considered preferable to sacrifice some of the values of the twin pillars of classical contract doctrine, certainty and predictability, in exchange for what are more relevant rationales and just results”).

77. Scott, *supra* note 76, at 858.

78. See *supra* note 62 and accompanying text.

79. This brings to bear the test posited by Posner and Rosenfeld: the better bearer of a risk is the party that would have incurred lower risk appraisal and lower transaction costs in insuring against that risk. Richard A. Posner and Andrew M. Rosenfeld, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 91 (1977).

courts are more likely just to opt for full contract performance.<sup>80</sup>

This analysis is not only difficult, but it also becomes circular. That is, if an event must be unforeseeable to support commercial impracticability then determining that one party is in a better position to have insured against the risk begs the question of unforeseeability. Going back to the issue of terrorism insurance, if the demand for this expensive/unobtainable product was not foreseeable at the time the mortgage was negotiated, how could one party or the other have hedged the risk?

Thus, the goal of the default rule must be redefined. Rather than certainty or efficiency, we can insert market transparency. The default risk (from known and unknown sources) should be reflected in the pricing and rating of the securities. This goal differentiates the ancillary risk discussion from the more traditional impracticability analysis. While the standard impracticability scrutiny centers on who bears the economic consequences of breach and moves on to compare expectation damages versus other types of damages, our examination veers off. In the CMBS arena, we are more concerned with presenting a true default profile to investors so as to allow intelligent and informed investment decisions. We then return to the question posed at the beginning of this discussion: Who bears the economic burden of changed circumstances that alter the default profile of a securitized loan—the property owner or the investor?

Based on the theory of commercial impracticability, it should be the investor that bears the risk for several reasons. First, a finding of commercial impracticability excuses the borrower from performance. Hence, if an unforeseen circumstance excuses performance, it would be illogical to then foist the burden of the changed circumstance onto the borrowers shoulders by forcing her to incur the cost of the change. Second, investors in the CMBS market are in a better position to bear the risk because they are better equipped to diversify.<sup>81</sup> CMBS securities holders are largely institutional investors with vastly diversified portfolios.<sup>82</sup> By comparison, most owners of the underlying real estate range from small developers with two or three properties to large developers who, while owning a large real estate portfolio, are still far less

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80. Scott, *supra* note 43, at 859. See, e.g., *Freidco of Wilmington, Del., Ltd. v. Farmers Bank of the State of Del.*, 529 F. Supp. 822, 830 (D. Del. 1981) (noting that the court refused the landlord's claim of impracticability of a cap on utility reimbursement). "Discharge or alteration of contractual obligations is an extraordinary remedy, however, and is not justified absent a showing of the occurrence of an event which has in fact rendered performance commercially impracticable." *Id.*

81. See Poindexter, *supra* note 1, at 532.

82. *Id.*



diversified than the pension fund that buys CMBS securities.

This leads to the default rule of contract interpretation in the event of ancillary risk: *If the ancillary risk results in commercial impracticability that would excuse the borrower from performing, the investor bears the risk of the cost of changed circumstances.* Putting this in the context of terrorism insurance, the loan servicer could not demand and could not force place the insurance. A logical extension of the application of this ex post rule would result in an ex ante inclusion of unforeseen risk in the initial pricing of the security. Investors, knowing they would bear the risk of unforeseen circumstances would possibly demand a higher yield from the inception of the transaction to compensate them for undertaking the unknown risk.

This would, in essence, shift some of the burden back onto the shoulders on the property owners as their cost of financing would increase. This is not necessarily a bad outcome. It complements the argument of prevailing legal theory that burden of non-performance should be shared and allocated on an economically efficient basis. Furthermore, it preserves the goal of certainty in contract interpretation—the property owner knows exactly the cost of the contract at the outset of the transaction.

## VI. CONCLUSION

The above-articulated default rule would assign a value to a previously unquantified risk. Waiting for the unforeseen event to occur and then reacting often results in a panic that overstates and magnifies the risk. By transforming ancillary risk into a pricing element, investors get a clearer picture of the risk presented by the CMBS pool. Owners would therefore gain the benefit of the certainty of contract as a property right that is reflected in their financing costs. Last but not least, a higher level of transparency and recognition of ancillary default risk will promote a more efficient and robust rating/pricing scheme.