



## CMBS Loan Special Servicers Rack Up Fees — And Lawsuits

Law360 Real Estate Authority

Georgia Kromrei

June 12, 2024

[\[Link\]](#)

Commercial mortgage-backed securities borrowers have long chafed at special servicers, who they say drag out negotiations and collect fees as long as possible while their distressed real estate assets languish.

Mostly, there is little borrowers can do. CMBS deals are structured to protect special servicers from litigation, and owners of individual real estate assets don't often have the same legal fire power.

But a recent crop of lawsuits and counterclaims against special servicers, including a high-profile suit filed by billionaire Carl Icahn, may make it harder for special servicers to continue business as usual.

In one ongoing case in the Circuit Court of Cook County, special servicer Rialto Capital Advisors sought to foreclose on an art deco-style office building at 20 N. Wacker Drive that houses the Lyric Opera of Chicago. The borrower, Manhattan-based investment firm 601W, filed a counterclaim on May 31 calling Rialto's practices "predatory."

Christopher Sullivan, a partner at Nutter McClennen & Fish LLP, who represents the building's owner, declined to comment. Counsel for Rialto did not respond to a request for comment.

Rialto came on the scene as special servicer in 2020, after the building's rental income took a nosedive. Before negotiating a workout, Rialto required 601W to sign a letter governing the terms of the negotiations, 601W said. The landlord also furnished financial records to Rialto. But then, Rialto went silent, according to 601W. When it asked Rialto to approve payments from rental income for broker commissions and payments for prospective tenants to build out their space, it got crickets. 601W complained that while Rialto did not respond to its requests to pay day-to-day expenses, it kept paying the debt service.

Rialto later foreclosed on the building. 601W says Rialto's actions made the foreclosure inevitable. In addition to a breach of the covenant of good faith and fair dealing, Rialto had "unclean hands" and shouldn't have been allowed to foreclose on the building, 601W claimed.

While 601W was trying and failing to rent out the office building, Rialto was examining the financial records 601W had furnished. 601W had used capital contributions to fund building operations in 2019 and 2020. Rialto identified the contributions as unpermitted "affiliate loans" in subsequent filings.

Taking on debt triggered full recourse for the loan, according to Rialto, which **sued** the landlord's guarantor for \$205 million in New York's Southern District in April 2023. The amount Rialto sought included the debt, damages, expenses, interest, advances and attorney fees.

601W called it a "bad faith after-the-fact attempt to exert pressure on 601W to abandon its resistance to[its] foreclosure effort."

"Throughout this process, Rialto has been inflating its own financial cut of the proceeds of the loan," 601W wrote in its May 2024 counterclaim. 601W said that as of November 2023, Rialto and Wells Fargo, the master servicer, are owed \$56 million in interest and fees, as well as a \$1.3 million special servicing fee.

Distress and high interest rates mean lots of work for special servicers, which are tasked with turning distressed loans around or foreclosing. While they do their work, the special servicers collect a small fee.

But additional fees, including for defaults and loan modifications, can add up to relatively large sums, as in the case of 601W. Interest charged on fees, once a trivial consideration, can now take a big bite out of borrowers' investments.

The 601W counterclaim is one example of a growing backlash against special servicers as commercial real estate distress festers. Icahn's high-profile suit against a special servicer has now survived motions to dismiss, and foreclosure counterclaims and lawsuits by borrowers are piling up and moving forward.

Counsel for borrowers are sharing notes and taking aim at one servicer in particular: Rialto Capital Advisors, one of the largest and, according to lawsuits and interviews, most aggressive.

"I can't affirmatively say there aren't other sharks out there," said William W. Weisner, chair of the real estate practice at Tarter Krinsky & Drogin LLP. "The special servicers you never hear from, like Rialto, they're happy to collect their money and fees."

### Borrowers Take Shots at Rialto

At least a dozen lawsuits and counterclaims have been brought against Rialto since the COVID-19 pandemic began, alleging the servicer-maintained control over assets for longer than necessary to maximize fees, held up sales and refinances by keeping borrowers in the dark, and charged improper fees.

Borrowers are often surprised at special servicers' aggressive tactics, in comparison with the lenders that originated their loan. But that should not come as a surprise, since special servicers have a different business model than banks do, said Gregory Cross, a partner at Venable LLP who chairs its CMBS practice and frequently represents special servicers.

Cross explained that in a traditional commercial lending situation, a borrower may have five or 10 loans with a bank, which the bank views as one balance sheet. On the other hand, special servicers are tasked with maximizing recovery for every loan, Cross said.

"Every special servicer is tasked with maximizing the recovery of the trust — if they don't, they are breaching their duty to the trust," Cross said. "They try and collect what's owed. The special servicers have to calculate on a net present value basis what is the highest recovery for the trust, and that's what they do."

In 2021, Rialto sued to foreclose on a mall in downtown Jamaica, Queens, an ethnically diverse enclave, whose tenants include an Old Navy and a branch of the State University of New York that provides vocational and college-level classes for low- to moderate-income households.

The foreclosure suit — filed shortly after New York banned many commercial foreclosures — said the owner of the mall, Mattone, had missed payments starting in April 2020. Six months later, the special servicer accelerated the loan and demanded full payment.

Mattone had missed six payments of about \$350,000 each, but as the foreclosure proceedings lurched forward, the bill increased sharply. When Rialto provided a "bring current" statement, the total owed by Mattone stood at more than \$14 million, compared to only \$2.4 million in arrears.

Mattone called the figure "shocking" and "astonishing" in court filings.

Mattone also said the timing of the bill was part of Rialto's scheme to drag out the process. The demand for \$14 million had been provided to Mattone days before a key court deadline. When the mega-bill arrived, it was not on official letterhead, but an Excel spreadsheet, and it was riddled with errors, according to Mattone's counsel. It took Rialto another nine months to provide a formal statement on company letterhead, which Mattone ultimately alleged included fabricated fees.

All the while, as the lawsuit dragged on, the special servicer accrued fees. Mattone alleged in a March 2023 amended counterclaim that this was exactly its plan: Rialto was trying to keep the mall in limbo to prolong the fees.

"Upon information and belief, lender and Rialto's tactic was and is an effort to prolong the period during which the loan is in special servicing in order to extract even more dollars for themselves under the loan agreement," the mall owner said in the counterclaim.

Mattone also sought sanctions against Rialto and its counsel, claiming Rialto doesn't possess the note, and make up for that, it cobbled together an electronic "manipulated" note.

The matter is still pending in the Southern District of New York.

Neal Kronley, of counsel at DLA Piper who represents Mattone, declined to comment. Counsel for the lender did not respond to a request for comment.

Many of the lawsuits brought by borrowers, which often pit small, regional law firms against those with national reach, have been dismissed or discontinued.

In one ongoing matter, a CMBS-financed Queens hotel sued the special servicer in New York's Eastern District in March 2024, accusing Rialto of interfering with the sale of a hotel that faltered after the outbreak of COVID-19 and capitalizing on the pandemic to demand fees. The complaint followed foreclosure filed by Rialto seeking to appoint a receiver.

In the federal lawsuit, the borrower, Long Island City Partners, alleged that Rialto held the sale "hostage" by demanding the borrower pay upfront fees. The sale ultimately fell through, and the would-be buyer separately sued the hotel in New York state court for not securing Rialto's permission before the sale.

According to Long Island City Partners, by the time of the scheduled sale, the loan had an unpaid balance of \$6.2 million, and Rialto claimed more than \$1 million in fees. Since then, with default interest and late fees, that figure has ballooned to \$11 million, Long Island City Partners alleged.

Counsel for Long Island City Partners did not respond to requests for comment. James S. Yu, senior counsel at Seyfarth Shaw LLP who represents Rialto, declined to comment.

### Borrowers Face Long Odds

In numerous recent lawsuits filed against special servicers, a pattern emerges: A relatively small real estate company, the owner of one asset in a pooled CMBS deal, sues the special servicer for the allegedly exorbitant fees they charge. The suits face long odds for a couple of reasons.

Special servicers often ask borrowers to sign "pre-negotiation" letters that make it harder to bring legal challenges as a condition for a loan modification. But even if borrowers do sue, the cases often do not survive initial motions to dismiss because they lack standing. When they do survive, borrowers are usually outgunned. Many such lawsuits are quickly dismissed.

"It's one borrower suing a special servicer, whereas the special servicer is lawyered up to handle hundreds of such suits, and the documents are in their favor," said Richard Fischel, a geologist-turned Cubature who, after stints at Willkie Farr & Gallagher LLP and a large state pension fund, is now a partner at Brighton Capital Advisors, a firm that advises CMBS borrowers and their counsel on navigating issues with servicers.

The business model of special servicing has in recent years shifted to seek more aggressive returns, Tarter Krinsky's Weisner said, with financial firms and asset managers piling into the sector. The structure of CMBS deals, meanwhile, has not changed to protect borrowers, who typically do not know which special servicer will control their loan.

"There are no checks and balances on the special servicer," Weisner said. "You thought this was a guy who changed your oil, formed your corporations, did your annual franchise tax filing, but now the financial

types have gone into it, there are zero protections for borrowers, and the special servicer can do whatever they want.”

It's also difficult for certificate holders to bring lawsuits, because of longstanding provisions in pooling and servicing agreements, including no-action clauses, designed to provide a buffer between the special servicer and investors. The structure is intended to allow special servicers to make business decisions without looking over their shoulder.

**“No-action clauses can be tough, especially if the trustee won't act,” said Robert Scheef, a principal at McKool Smith who specializes in structured finance litigation. Scheef said that one way certificate holders historically overcame obstacles to bring lawsuits against special services of residential mortgage-backed securities was by aggregating their claims, a strategy he has not seen in recent years in CMBS.**

Despite long odds, borrowers and certificate holders are taking their shot. Rialto, one of the largest servicers, is the most frequently targeted, according to a review of federal lawsuits filed against the top five special servicers by unpaid principal loan balance since 2020.

Why Rialto? Its possible Rialto draws so many lawsuits simply because of its size. Several lawsuits cite litany of other ongoing lawsuits targeting Rialto.

“There's a copycat aspect to many of the claims brought by borrowers,” Cross of Venable said.

Most of the lawsuits filed against Rialto are unsuccessful. But one matter in particular stands apart, and so far, it's not going away.

Sending a Message

Icahn, the activist investor who has very publicly bet against American shopping malls, says the conduct of Rialto and other special servicers puts the CMBS market at risk.

A 2022 lawsuit Icahn brought against Rialto in a Nevada state court has now survived a motion to dismiss and is in discovery. Icahn alleged that Rialto, the special servicer of a \$73 million CMBS loan on an outlet mall, committed fraud and cheated the trust's investors by pursuing its own interests, not those of the trust. The lawsuit alleged breach of contract and breach of the implied covenant of good faith and fair dealing, and it seeks a declaratory judgment that because of its conduct, Rialto is not indemnified from the CMBS investors.

Icahn claimed that rather than sell the property promptly, Rialto held the asset in special servicing for as long as it could, "artificially prolonging the life of a dying trust asset" and racking up a \$12 million bill.

Rialto disputes that figure.

Icahn alleged Rialto manipulated the appraisal — including by paying an ax-throwing company \$650,000 to take a lease at the mall — to keep the control from passing to the next tranche of bondholders, who would have sold the mall faster. The mall ultimately sold for just \$400,000 in 2021, after it spent 39 months in special servicing.

In the lawsuit, Icahn specifically calls out Rialto, but the suit also takes issue with special servicers in general. The complaint argues that Rialto's practices are "standard operating procedure" for many special services.

"Such servicer misconduct is often the product of self-interest and to the detriment of CMBS investors 'on the whole,' whose interests' servicers are bound to protect," the complaint said. "The free and fair operation of the CMBS market is routinely eroded when servicers artificially avoid recognizing manifest losses in the short term and, in doing so, exacerbate losses to CMBS investors in the long term."

The suit also alleges that Putnam Investments, an investment management firm that Rialto said insures against CMBS shorts, "attempted to influence Rialto's decision-making.

"Rialto fired back in its motion to dismiss in July 2022, characterizing Icahn's complaint as "full of vitriol and reckless, inaccurate accusations." Rialto argued that Icahn was not an investor in the bonds until after the mall had been foreclosed on, so he did not incur any financial loss and could not have satisfied the reliance requirement for a fraud claim. It also argued that since only bondholders who are entitled to distributions have standing to sue, the case should have been dismissed.

The special servicer defended the appraisals of the mall, which were conducted by CBRE Group, commercial real estate services and investment firm. Rialto also pushed, unsuccessfully, for the case to be heard in New York City — where the loan was originated and where the pooling and servicing agreement was executed — not in Nevada. The motion to dismiss argued that the forum of New York made sense, particularly because the 152 properties serving as collateral for the 48 loans in the pool are located in 34 different states.

Rialto also argued that the CMBS trust's pooling and servicing agreement contains provisions that protect special servicers from claims like Icahn's.

"These are key bargained for protections that are intended to allow the master servicer and special servicer to perform their duties without fear of frivolous litigation by disgruntled investors who disagree with their decisions," Rialto argued in its motion to dismiss.

Subpoenas to depose Carl Icahn, as well as the firm that sold him the bonds, were issued earlier this year. Counsel for both parties declined to comment.

The case involving the mall in Nevada is Icahn Partners LP et al. v. Rialto Capital Advisors LLC, case number A-22-854147-B, in the Eighth Judicial District Court in Clark County, Nevada.

Icahn Partners is represented by Michael A. Hanin, Edward E. Felsch, Jill L. Forster and Andrew Breland of Kasowitz Benson Torres LLP.

Rialto Capital Advisors LLC is represented by Gregory A. Cross, Colleen Mallon Casse, Konstantina A. Calabro and Georgios Soumalevris of Venable LLP, J. Colby Williams of Campbell & Williams, and Jake M. Greenberg and Philip R. Stein of Bilzin Sumberg Baena Price & Axelrod LLP.

The case involving the Chicago opera house is Wells Fargo Bank, National Association, As Trustee For The Benefit Of The Registered Holders Of JPMBB Commercial Mortgage Securities Trust 2015-C31, Commercial Mortgage Pass-Through Certificates, Series 2015-C31 v. SL Civic Wacker LLC, case number 2021 CH03945, in the Circuit Court Of Cook County, Illinois County Department, Chancery Division.

SL Civic Wacker LLC is represented by Gerald B. Lurie of Chen Law Firm Ltd., Christopher J. Sullivan, John C. Leddy and Michael J. Leard of Nutter McClennen & Fish LLP.

Wells Fargo Bank, which is acting by and through Rialto as special servicer, is represented by Jason J. DeJonker, Mark L. Johnson and Aaron Davis of Seyfarth Shaw LLP.

The case involving the mall in Jamaica, Queens, is U.S. Bank National Association, As Trustee On Behalf Of The Registered Holders Of GS Mortgage Securities Corporation II, Commercial Mortgage Pass Through Certificates, Series 2012-GCJ9, Acting By And Through Rialto Capital Advisors, LLC, As Special Servicer Under The Pooling And Servicing Agreement Dated As Of November 1, 2012 v. Michael X. Mattone And Carl F. Mattone, case number 1:23-cv-11035, in the U.S. District Court for the Southern District of New York.

Rialto Capital Advisors LLC is represented by Baron C. Giddings, David V. Mignardi and Keith M. Brandolino of Holland & Knight LLP.

Michael X. Mattone is represented by Neal F. Kronley of DLA Piper.

The case involving the hotel in Queens is Long Island City Partners LLC v. U.S. Bank National Association, As Trustee For The Registered Holders Complaint Of The WFCM 2013-LC12 Mortgage Trust Commercial Mortgage Pass-Through Certificates, Series 2013-LC12, And Rialto Capital Advisors LLC, case number 1:24-cv-02004, in the U.S. District Court for the Eastern District of New York.

Long Island City Partners is represented by Stephen C. Nappi of Nappi Klozow LLP.

Rialto Capital Advisors LLC is represented by James S. Yu of Seyfarth Sha