New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION

An ALM Publication

REAL ESTATE Law & Practice

WWW.NYLJ.COM

MONDAY, NOVEMBER 23, 2009

Federal Relief for **Distressed Commercial** Market

New REMIC tax regulations, revenue procedure provide hope but obstacles remain.

BY ANDREW LANCE, ROMINA WEISS AND DANIEL WASSERMAN

ON SEPT. 16, 2009, the Treasury Department and the Internal Revenue Service concurrently released final regulations[1] and a revenue procedure[2] governing the U.S. federal income tax treatment of collateralized mortgage-backed securities (CMBS) held by a real estate mortgage investment conduit (REMIC).[3] Following issuance of the regulations and the revenue procedure, the Federal Reserve (in conjunction with the FDIC and numerous other federal regulatory agencies) released comprehensive revised guidance for commercial real estate loan modifications.[4]

These coordinated actions demonstrate a welcome heightened focus at the federal level on the expanding crisis in commercial real estate that until now has been overshadowed at the regulatory level by efforts to deal with a parallel crisis affecting residential real estate. Practitioners providing counsel regarding distressed real estate need to become familiar with these developments, as part of the framework for crafting approaches to address existing, imminent or anticipated distress at commercial real estate assets.

Since the close of 2007, the real estate capital and credit markets have experienced an unprecedented crisis fueled by a bubble of leverage that inflated over the last decade. While the impact in the commercial property market has lagged the widely covered developments in the residential market, the absence of capital for owners to refinance mortgages at maturity, and the erosion of rental revenues reflecting the broader economic climate, have caused delinquencies to soar while prices for commercial real estate have declined significantly in most regions and for most asset types.

ANDREW LANCE *is a partner in Gibson, Dunn & Crutcher's real estate department,* ROMINA WEISS *is a partner in the firm's tax department and* DANIEL WASSERMAN *is an associate in Gibson Dunn's real estate department. All reside in the New York office.*

The lack of transaction volume to inform pricing, coupled with uncertainty about what will be "normal" loan-to-value ratios when credit returns to the market, has made valuations almost speculative, helping perpetuate a wide bid-ask spread between buyers and sellers. Meanwhile, the average value of distressed mortgages previously sold off by issuing banks to investors has eroded as foreclosures, tenant business failures and bankruptcies eat into expected returns and bring more property to a market starved for debt capital.

Eager to avoid the costly, time-consuming foreclosure process and to keep borrowers performing on their loan obligations, investors in CMBS have been pleading with federal regulators to ease restrictions on workouts of currently performing loans in foreseeable danger of default when, for example, interest rates escalate, amortization commences, debt service reserves are exhausted, the loans mature, or collateral performance deteriorates. Borrowers have simultaneously sought to proactively engage the servicers assigned to administer their mortgages in order to head off further foreclosures.

In response to these concerns, the IRS described the new regulations and the revenue procedure as a response to the commercial real estate industry's concerns with the difficulties of modifying distressed mortgages prior to a borrower's actual payment default. In essence, the rules reflect recognition of the practical realities that it is possible to foresee the risk of default in advance of such a default, and that in such instances acting prior to default may be prudent on many levels and may help mitigate, defer or avoid a loss.

The regulations and the revenue procedure thus address a critical and substantial roadblock to pre-default workouts that would have prevented the modified loans from being "qualified mortgages" when held by a REMIC (and possibly resulting in a "prohibited transaction" tax on the REMIC).

'Significant Modifications'

If a loan held by a REMIC undergoes a "significant modification" for U.S. federal income tax purposes, the loan will generally no longer constitute a "qualified mortgage."

Proposed regulations had previously provided certain exceptions to this rule for assumptions of the obligation, waiver of a due on sale or due

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on encumbrance clause, and conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage. The regulations provide additional exceptions to this rule by permitting releases of liens and changes in collateral, guarantees, credit enhancement and to the recourse nature of an obligation, as long as the mortgage continues to be "principally secured by real property" after the modification.

The 'Principally Secured' Test

The requirement that the loans be "principally secured" by real property has also been amended to remove certain obstacles to debt workouts.

Mortgages held by a REMIC must be secured by real property with a fair market value equal to at least 80 percent of the mortgage's adjusted issue price. This loan-to-value test must be satisfied either at the time the security is originated or at the time the security is contributed to the REMIC. If the loan is later modified, the test must also be satisfied at the time of that modification.

The regulations introduce an "alternative test" in the context of a modification. If a loan is modified but the underlying property is no longer valued at 80 percent of the adjusted issue price of the security, the loan will still be considered "principally secured" if the fair market value of the real property interest after the modification equals or exceeds its pre-modification value.

In other words, as long as the value of the secured interest is not impaired by the loan restructuring, a mortgage security will continue to satisfy the "principally secured" test regardless of whether the value of the real property interest securing the loan had depreciated prior to the modification.

Substantiating Value

Under prior proposed regulations, the determination of the value of a real property interest at the time of a significant modification required a current appraisal by an independent appraiser.

The regulations relax this requirement in order to permit workouts to proceed on an expedited and cost-effective basis. The regulations provide more flexibility in substantiation of value, providing that the "principally secured" test will be satisfied if there is a reasonable belief that the modified mortgage loan satisfies the 80 percent test at the time of the modification.

A reasonable belief may be based on any commercially reasonable valuation method. Such methods include, but are not limited to, a current appraisal by an independent appraiser, an appraisal obtained in connection with the origination of the obligation that has been appropriately updated for the passage of time and for other relevant changes, and the sales price of the real property interest in the case of a substantially contemporary sale in which the buyer assumes the seller's obligations under the mortgage.

Of course, in practice, today, reliance on an appraisal may be tricky. The dearth of transactions means that there are few comparables on which to base values and cap rates. Uncertainty regarding what stabilized leverage ratios will be, and when leverage will return, has appraisers struggling, and in some cases delivering appraisals with multiple valuations based on a variety of alternative assumptions.

Nevertheless, because special servicers themselves are at the center of what action there is today, servicers of distressed assets often are equipped with market information that will be valuable in applying the regulations to actual assets.

The **expanding crisis** in commercial real estate had, until now, been **overshadowed** at the regulatory level by efforts to deal with a **parallel crisis** affecting residential real estate.

Pre-Default Modifications

The revenue procedure provides circumstances under which modifications of loans held by a REMIC may be pursued in connection with deteriorating, yet technically-performing, mortgage loans without causing such mortgages to cease being "qualified mortgages" or subjecting the REMIC to a "prohibited transaction" tax.

Modifications may be pursued by the servicer and a borrower not only if there has been a default, but also if a "reasonably foreseeable default" can be established. Whether a default is reasonably foreseeable is based on the totality of the circumstances, and the servicer must conduct due diligence sufficient to show a "significant risk of default."

Depending on the circumstances, a servicer may demonstrate a significant risk of default even if the loan presents no imminent signs of non-performance. Moreover, there is no limit to how far in advance of maturity a loan may be treated as showing a "significant risk of default."

Accordingly, as long as a servicer reasonably believes that the existing loan shows a "significant risk of default" and the modified loan presents a "substantially reduced risk of default," even if the loan does not appear to be at risk of non-performance in the short term, the loan may be modified.

Commentary and Consequences

The regulations and the revenue procedure reflect an awareness of the realities of today's challenging commercial real estate market.

Maturing and overleveraged commercial real estate loans have become a consuming issue for the industry, as well as an emerging threat to the recovery of the overall economy. Recent testimony before Congress' Joint Economic Committee (JEC) indicated that, over the next decade, an estimated $400 billion in commercial real estate loans per year will mature and become immediately payable. Especially hard hit has been the hotel business, with $6.83 billion in currently delinquent loans.

As pointed out by JEC chairwoman Carolyn Maloney (D-N.Y.) in a letter to Treasury Secretary Timothy Geithner, property owners who foresee eventual defaults on their mortgages will be unwilling to inject fresh capital and resources into their original investment, in turn affecting related industries and slowing down the nation's recovery. Further action removing tax obstacles to loan workouts may help borrowers achieve a long-term solution to their mortgage woes and incentivize them to undertake construction and operating improvements that will put the complementary industries back to work.

Although many hope that the new rules will usher in an era of mortgage workouts, obstacles remain.

Servicers have contractual duties to REMIC investors under pooling and servicing agreements (PSAs) which may be inconsistent with the latitude the new rules afford. Moreover, while certain modifications such as lien releases, collateral substitutions or changes in the recourse nature of the obligations may be accorded "safe harbor" status, it remains to be seen whether more significant modifications such as principal forgiveness, interest rate and amortization rate modifications, extensions of maturity, or partial subordinations to new capital infusions will be considered acceptable.

Federal Reserve Guidance

Following issuance of the regulations and the revenue procedure, the Federal Reserve released comprehensive revised guidance for commercial real estate loan modifications.[5]

In its statement, the co-authoring agencies note that they "have found that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower," especially when the negotiations involve "creditworthy customers who have the willingness and capacity to repay their debts."

Accordingly, their guidance encourages examiners to take a "balanced approach in

assessing the adequacy of an institution's risk management practices for loan workout activity," and provides that, if a financial institution engages in commercial real estate loan workouts after appropriate diligence, it will not be subject to criticism, even if the restructured loans have weaknesses that result in adverse credit classification.

Unresolved Issues

Although Treasury's recent move has been supported by other federal agencies, not all participants in the CMBS arrangement will favor the flexibility afforded by the recent guidance.

Borrowers and junior creditors may favor the flexibility, but servicers may be worried about added pressure to balance, rather than prioritize, the interests of senior debtholders. Senior creditors may prefer to see the REMIC foreclose on its mortgages and satisfy its loans in full, while junior debtholders may prefer to modify the obligation and hope for improvement.

Servicers will have to carefully negotiate the conflicting interests between the various debt tiers subject to an intercreditor PSA and adhere to often ambiguous "servicing standard" directives to maximize to the recoveries by all creditor classes.

For example, the PSA servicing standard typically requires servicers to evaluate the net present value of recovery on loans in danger of default and foreclosure. The servicer must make highly speculative assumptions about the value of future leases, operations and market conditions, incorporating these predictions into the calculus of whether to offer the borrower a modification of loan terms or to stand tough and risk foreclosure.

Further complicating the picture are those situations where the servicer has an interest in a particular tier of CMBS debt or ownership interest in a REMIC, because the servicer may be faced with a conflict between its position and that of other debtholders.

In addition, the revenue procedure does not extend to situations where a loan modification may not reduce the probability of a borrower default, but may reduce investor losses in the future. A servicer and borrower may be inclined to agree to a workout that reduces monthly payments but does not write down outstanding principal or extend the maturity date of the debt. In such a scenario, foreclosure would be delayed somewhat by the lower monthly payments, but the borrower may still prove unable to meet its principal obligations at maturity.

Though an immediate foreclosure could make the senior creditors whole while shutting out subordinate classes, a workout may extend loan performance for several years, covering eventual losses by junior debt while postponing the payout to senior creditors.

Is It Enough?

Practically speaking, the regulations and the revenue procedure may not provide much short-term relief for currently performing borrowers.

As noted above, servicers administering CMBS loans are principally bound by the PSA provisions on which the holders of interests in the REMIC relied; the new guidance will not supersede more restrictive PSA workout provisions.

Under many PSAs, performing loans are generally administered by a "master servicer" which typically has little discretion to modify loans and, in some cases, does not have the requisite authority to renegotiate terms. In the past, loans were not transferred to the "special servicer," who has much greater latitude to initiate and engage in workouts, until the borrower had defaulted.

Practically speaking, there may not be much **short-term relief** for **currently performing borrowers** because the new guidance will not supersede more restrictive workout provisions in **pooling and servicing agreements**, by which servicers administering CMBS loans are principally bound.

The regulations and the revenue procedure may provide insufficient real world comfort to borrowers seeking to engage in pre-default discussions with the administrators of REMIC-held loans. However, they could instead become the basis for servicers to act earlier rather than waiting for a default to occur, and also could counter the perception among borrowers that a default must occur in order to get the servicer's attention. In fact, special servicers have noted in recent months an increase in the volume of voluntary pre-default referrals in an attempt to jumpstart negotiations before the borrower's position further deteriorates.

Even if the regulations and the revenue procedure mark a breakthrough for mortgage workout business, some industry insiders wonder whether these changes will reform CMBS and its waning attractiveness to investors. Granting special servicers the tax-regulatory freedom to modify loans may earn these investments a second look. Throwing the servicer's enhanced role into the mix will force investors to investigate not just underlying assets and credit risks, but also the reputation and track record of the servicers entrusted with maximizing CMBS returns.

Conclusion

Despite many concerns and uncertainty surrounding the regulations and the revenue procedure, most sectors of the commercial real estate industry have applauded these actions.

Senior CMBS debtholders are the most visible holdouts, concerned that their priority position will be adversely affected by extensions of maturity in a still-declining market and by workouts that compromise terms that were material to their underwriting. Other CMBS investors, however, are supportive of empowering servicers to negotiate and extend the performance of as many mortgages in the investment pool as possible, even on modified terms.

The industry now hopes that Treasury's latest initiative, reinforced by the recent Fed policy shift, broadens the arsenal of tools available to servicers to address the needs of distressed real estate loans and liberates servicers to act sooner and more creatively.

1. T.D. 9463, 2009-40 I.R.B. 442.
2. Rev. Proc. 2009-45, 2009-40 I.R.B. 471.
3. The rules provided in the revenue procedure also apply to CMBS held through fixed investment trusts, but the rules provided in the regulations do not. In IRS Notice 2009-79, issued the same day, the Internal Revenue Service requested comments as to whether the rules contained in the regulations should be expanded to apply to fixed investment trusts as well.
4. "Policy Statement on Prudent Commercial Real Estate Loan Workouts," Oct. 30, 2009 (available at http://www.federalreserve.gov/boarddocs/srletters/2009/sr0907a1.pdf).
5. Id.

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