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Clients&FriendsMemo

Treasury Department Guidance Issued on Modification of Securitized Commercial Mortgage Loans

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Introduction

On September 15, 2009, the Internal Revenue Service (the "IRS") issued the following three releases, each providing guidance on the ability of a servicer to modify securitized commercial mortgage loans:

(i) Revenue Procedure 2009-45 (the "Revenue Procedure"), describing conditions under which commercial mortgage loans that have a "significant risk of default" may be modified without having an adverse effect on their status in a real estate mortgage investment conduit ("REMIC") or fixed investment trust;[1]

(ii) final regulations (the "Final Regulations") generally permitting certain changes in collateral and credit enhancement for commercial mortgage loans securitized in REMICs if certain conditions are met;[2] and

(iii) Notice 2009-79 (the "Notice"), requesting comments on the appropriateness of expanding the guidance described in the Final Regulations to commercial mortgage loans securitized in fixed investment trusts (grantor trusts).[3]

Taken together, the new guidance indicates an effort on the part of the IRS to relax certain restrictions relating to the modification of commercial mortgage loans in order to assist the efficient administration of performing loans and to maximize the ability of troubled loans to perform in accordance with their modified terms. The guidance will impact the parties to a securitization in various ways, but primary emphasis is placed on the standards for determining whether

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1 http://www.irs.gov/pub/irs-drop/rp-09-45.pdf

2 http://edocket.access.gpo.gov/2009/pdf/E9-22215.pdf T.D. 9463, F.R.Doc 2009-22215, 74 Fed. Reg. 47436 (Sept. 16, 2009) amending Treas. Reg. §§ 1.860G-2(a)(8) and 1.860G-2(b). While residential mortgage loans are not excluded from the coverage of the Final Regulations, the modifications are of a type usually encountered in commercial mortgage loan administration.

3 http://www.irs.gov/pub/irs-drop/n-09-79.pdf

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modifications proposed by borrowers are permitted under the new guidance. The new rules have no impact on any non-tax, contractual restrictions on loan modifications that may be contained in securitization documents.

Revenue Procedure 2009-45

Summary

Under existing law, mortgage loan servicers are not permitted to modify securitized mortgage loans in a manner that results in a "significant modification," with an exception for loans in default or as to which default is "reasonably foreseeable." The Revenue Procedure expands the circumstances under which a commercial mortgage loan[4] in a REMIC or grantor trust may be modified by expanding the interpretation of when default is "reasonably foreseeable" to include loans as to which the servicer believes there is a "significant risk of default." The Revenue Procedure also provides some guidance as to how and when a servicer may reach its determination that the risk of default is "significant."

A servicer's belief that a loan faces a "significant risk of default" must be based on a "diligent contemporaneous determination of that risk," which may take into account "credible written factual representations" of the borrower, if the servicer "neither knows nor has reason to know that such representations are false." One element in this determination is how long prior to maturity or the possible default the determination is made. The IRS states that there is no maximum period, and gives as an example a foreseen default "more than one year" in the future. The fact that a mortgage loan may be currently performing, with no history of default, does not prevent a servicer from determining that default is reasonably foreseeable for these purposes.

The Revenue Procedure gives an example of a loan that will mature in 12 months. If the unavailability of refinancing options is demonstrated either by current economic conditions in the credit markets or the current fair market value of the property securing the loan relative to the amount of debt, then default on that loan may be deemed "reasonably foreseeable." The servicer may rely on a representation from the borrower for the conclusion that there is a "significant risk of default" so long as it does not know or have reason to know that the borrower's representation to this effect is false. The net effect of these guidelines may be to allow servicers to give borrowers breathing room to deal with their troubled loans or properties significantly in advance of their maturity date.

If the above guidelines are met, the IRS will not:

[4] Including multifamily loans (secured by residential properties having no fewer than five dwelling units).

(i) challenge the qualified status of a REMIC based on default on the loan not being reasonably foreseeable or deem the REMIC's regular interests to be reissued;

(ii) assert that a REMIC prohibited transaction has occurred; or

(iii) assert that a grantor trust is disqualified as a result of a prohibited power to modify the loan.

Effective Date

The Revenue Procedure is effective for all loan modifications effected on or after January 1, 2008.

The Final Regulations

Summary

In November 2007, the IRS issued proposed regulations (the "Proposed Regulations")[5] designed to permit certain types of modifications to commercial mortgage loans held by a REMIC without jeopardizing the qualification of the REMIC or causing a prohibited transaction with respect to the mortgage loan. The Proposed Regulations were responsive to requests from the commercial mortgage loan servicing industry dating from 2004. They were not prompted by, and not adopted in final form as a response to, the credit crisis in commercial real estate. The Final Regulations finalize the Proposed Regulations with certain significant clarifications. The main clarifications in the Final Regulations are the following:

1. Expansion of Permitted Modifications to Performing Loans. Releases, substitutions and additions of collateral and changes in guarantees, other credit enhancement or the recourse or nonrecourse nature of a loan will be allowed even if they are "significant modifications" (under Treasury Regulations Section 1.1001-3), as long as the mortgage loan remains "principally secured" by real property, as defined in the regulations (see paragraph 3 below). For example, material substitutions of collateral will be permitted (to the extent allowed under the securitization documents), adding significant flexibility to loan administration.

2. New Condition to Modifications to Performing and Non-performing Loans. Releases or substitutions of collateral and changes in guarantees, other credit enhancement or the recourse or nonrecourse nature of a loan that were allowed under prior law, including (i) changes to a mortgage loan that is in default or as to which a default is reasonably foreseeable, (ii) changes that are not significant, and (iii) changes unilaterally permitted

[5] Prop. Treas. Reg. § 1.860G-2(b), 72 Fed. Reg. 63533 (Nov. 9, 2007).

to be made by the borrower pursuant to the loan documents, will only be allowed if the "principally secured" test referred to above is met. The "principally secured" requirement in these circumstances was not required under prior law.

3. Standard for Determining "Principally Secured". For purposes of these permitted changes in collateral, credit enhancement and recourse, the new test for "principally secured" is that either:

    (i) the loan is at least 80% secured by real property, i.e., a loan to value ("LTV") ratio of not more than 125%, measured by the fair market value of the property(ies) immediately after giving effect to the modification, or

    (ii) the value of the property(ies) securing the loan after the modification is equal to or greater than the value of the property(ies) securing the loan prior to the modification.

For purposes of determining the fair market value of real property to determine whether a loan remains "principally secured" by real property, any reasonable method may be used, including a new appraisal, an original appraisal that is updated as appropriate, a recent sale price of the property, or another "commercially reasonable valuation method" (for example, the latter could include a "desk" appraisal or a broker's price opinion).

Concerns

The inclusion of the "principally secured" test for modifications that were allowed under prior law (paragraph 2 above) may require further clarification to remove a potentially problematic element. Under the Final Regulations, modifications that were permitted under prior law, e.g., releases at the unilateral option of the borrower, non-material releases, and releases when default has occurred or is reasonably foreseeable, must now meet the "principally secured" test. For example, if a loan has a 135% LTV prior to the date of the modification (e.g., due to a severe decline in the value of the real property), and the servicer enters into a modification that would involve a partial paydown of the loan in connection with a release of a portion of the collateral, the LTV would be lowered to 130%. Since the loan is over 125% LTV after giving effect to the modification, the alternative test under the Final Regulations requires that the modification not result in any decline in the aggregate *fair market value* of the real property. Since any release of collateral reduces the fair market value of the overall real property securing the loan, as the Final Regulations currently read this modification would be prohibited, even though the LTV improved. This would be true even in a default situation or pursuant to a unilateral option of the borrower. This result was probably not intended, and a more appropriate requirement would be that the change not result in an increase in the LTV, as well as an exception for default-related releases. We intend to bring this concern to the attention of the IRS.

Effective Date

The Final Regulations are effective September 16, 2009 and will apply to all mortgage loan modifications made on or after that date.

Notice 2009-79

The Notice, issued simultaneously with the Final Regulations, notes that the industry sought guidance on permitting the same types of loan modifications in fixed investment trusts (grantor trusts) as the Final Regulations allow for REMICs. The preamble to the Final Regulations states that the IRS did not want this request to further delay the issuance of the REMIC guidance. The Notice therefore invites comment on the appropriateness of allowing modifications of commercial mortgage loans held in grantor trusts. Transactions that might be covered by such a rule include single large loan securitizations formed as grantor trusts and pooled transactions where a portion of a loan is held in a REMIC and a portion is held in a grantor trust within the same issuing vehicle.

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If you have any questions regarding the foregoing, other aspects of these IRS releases, or other related REMIC issues,[6] please contact:

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[6] For example, the IRS releases described in this memorandum do not address or relate to initiatives by various industry participants to expand the scope of permissible REMIC activity to include financing by REMICs in connection with sale of foreclosure property owned by the REMIC.

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