Client Advisory

Katten
Katten Muchin Rosenman LLP

Real Estate/Tax

September 22, 2009

IRS and Treasury Issue Guidance for Modification of Securitized Commercial Mortgages

In recent years, a significant portion of all commercial mortgage loans have been securitized, and now are held by trusts characterized as real estate mortgage investment conduits (REMICs) for federal income tax purposes. The trust issues bonds or pass-through certificates using the cash flow from the underlying mortgage loans to make the required payments to the certificateholders. This tax treatment allows the trust to be considered a pass-through entity, which is not taxed at the entity level. In exchange for such favorable tax treatment, REMICs are subject to a number of requirements. One such requirement is that the REMIC must hold a static pool of mortgage loans, so that new mortgage loans are prohibited from being added (with limited exceptions). The Internal Revenue Service (IRS) also views certain material modifications to existing, non-defaulted mortgage loans to be so significant that modifying the loan is deemed adding a new loan to the pool, a prohibited action. Accordingly, a "master servicer" of the mortgage loans held by a REMIC historically has had very little latitude to modify a loan without risking the pass-through tax status of the REMIC.

Notwithstanding the general prohibition on material modifications to non-defaulted loans, once a loan is in default (or at risk of "imminent default"), the REMIC regulations do permit a material modification. Under the pooling and servicing agreements (each a "PSA") that govern most REMICs, such loans are transferred to a "special servicer" who has the authority, subject to limitations in the applicable PSA, generally to negotiate significant modifications if such modifications maximize the recovery to the certificateholders.

On September 15, 2009, the IRS issued Revenue Procedure 2009-45. This Revenue Procedure now allows, under certain circumstances, material modifications to a mortgage loan held by a REMIC (including a mortgage loan that is not currently in default or in imminent risk of default) without jeopardizing the pass-through tax status of that REMIC. Specifically, under Revenue Procedure 2009-45, if the following four conditions are met, a modification of a mortgage loan held by a REMIC will not cause the IRS to challenge that entity's REMIC tax status:

- The Revenue Procedure applies to commercial mortgage loans and certain residential loans. It does not apply to a loan secured by a residence that (i) contains fewer than five (5) dwelling units, and (ii) is the principal residence of the borrower of the loan.
- At the end of the REMIC's three-month start up period, no more than 10% of the REMIC's loans at the time of their contribution either (i) had payments which were 30 days overdue, or (ii) were loans for which default was reasonably foreseeable.

For more information, please contact one of the Katten Muchin Rosenman LLP attorneys listed below:

Charlotte

Daniel S. Huffenus
704.444.2011 / dan.huffenus@kattenlaw.com

Chicago

David R. Dlugie
312.902.5274/ david.dlugie@kattenlaw.com

Reid A. Mandel
312.902.5246/ reid.mandel@kattenlaw.com

Marcia W. Sullivan
312.902.5535 / marcia.sullivan@kattenlaw.com

Los Angeles

Christine N. Fitzgerald
310.788.4459 / christine.fitzgerald@kattenlaw.com

Benzion J. Westreich
310.788.4409 / benny.westreich@kattenlaw.com

New York

Hays Ellisen
212.940.6669 / hays.ellisen@kattenlaw.com

Timothy G. Little
212.940.8594 / tim.little@kattenlaw.com

Washington, D.C.

Bruce E. Kosub
972.868.9058 / bruce.kosub@kattenlaw.com

- Based on all the facts and circumstances, the servicer reasonably believes that there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date. This "reasonable belief" must be based on "diligent contemporaneous determination of that risk." While Revenue Procedure 2009-45 does not list all the factors that may be, or should be, taken into consideration by the servicer, it does allow for "credible written factual representations" made by the borrower to be considered, provided the servicer neither knows nor has reason to know such representations are false. While the timing of any potential default may be a relevant factor to consider, there is no maximum period of time after which a default is "*per se* not foreseeable." The Revenue Procedure provides an example of a foreseeable risk that could be over one year in the future. Furthermore, while past performance is a factor to be considered when determining the risk of a default, it should not be used as the sole reason to prevent a currently performing loan from being considered at risk of default.
- Finally, the servicer must reasonably believe, based on all the facts and circumstances, that the modification of the loan would "substantially reduce the risk of default," as compared with the pre-modification loan.

In general, Revenue Procedure 2009-45 appears to be an attempt, championed by industry participants, to allow servicers of securitized commercial mortgage loans to address looming maturity defaults (given the lack of viable financing) without having to first wait for the loan to become non-performing.

Revenue Procedure 2009-45 is strictly limited to mortgage loans that satisfy all of the criteria listed therein. Should a servicer desire to modify a loan outside of the guidelines provided by Revenue Procedure 2009-45, it must ensure that the specific modification is not a "signification modification" as such concept is contemplated under Treasury Regulation 1.1001-3.

To that end, and in addition to the guidelines set forth in Revenue Procedure 2009-45, the Department of the Treasury and the IRS expanded the list of acceptable loan modifications that would not be considered "significant" under Treasury Regulation 1.1001-3 for loans held in REMICs. These new final regulations, effective as of September 16, 2009, include:

- changes in collateral, guarantees, and credit enhancement of a loan;
- changes to the recourse nature of a loan, from recourse to nonrecourse, and vice versa;
- a release of a lien on real property that does not otherwise result in a significant modification under Treasury Regulation 1.1001-3; and
- a release of a lien on real property caused by a default or a reasonably foreseeable default,

provided that the loan continues to be principally secured by an interest in real property.

A loan is considered to be principally secured by an interest in real property if the fair market value of the real property that secures the loan equals at least 80% of the adjusted issue price of the loan. The final regulations require a loan to be retested at the time of its modification, if it is modified with respect to its collateral, guarantees and credit enhancement, or with respect to its recourse nature. The final regulations provide an alternative to the regular test, whereby a loan will continue to be considered principally secured by an interest in real property if the fair market value of the real property that secures the loan immediately after such modifications equals or exceeds the fair market value of the real property that secured the loan immediately prior to the modification. The determination of the value of the real property that is securing the loan may be based on any commercially reasonable valuation method.

In pre-default discussions between servicers and borrowers, these changes could play a significant role. The ability to weaken (or tighten) the recourse obligations of a borrower, coupled with the ability to substantially alter the underlying collateral for credit enhancement purposes, should give servicers room to negotiate to effect a mutually beneficial change to a loan without putting a REMIC's tax status at risk.

The final regulations do not address the rules of modifications with respect to securitization vehicles that are formed as investment trusts. Under the investment trust rules, the trustee and servicer may not have any power to vary investments of the trust. Simultaneously with issuing the final regulations, the IRS and the Department of the Treasury issued Notice 2009-79, requesting comments as to which modifications should be allowed to be made by securitization vehicles that are formed as investment trusts.

It is important to note that in connection with any proposed loan modification, the servicer remains subject to the provisions of the applicable PSA, which in the case of material modifications typically requires the consent or action of the special servicer and controlling class certificateholder, as well as compliance with the "servicing standard" which requires the servicer to do what is in the best interest of certificateholders as a collective whole. The possibility of divergent interests among certificateholders continues to present significant challenges to servicers.

Given the growing pressures on commercial real estate loans and the commercial real estate industry as a whole, the new Revenue Procedure and final regulations, while not a cure-all, are a movement in the right direction. Certainly it will take time before borrowers, servicers and others in the REMIC industry know quite what to make of these changes and how they will be implemented. However, a significant hurdle to modifications has been removed, offering opportunities for restructuring previously unavailable.

9/22/09