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IRS Final Regulations On Commercial Loans in REMIC Transactions

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The Treasury Department took a small step forward to provide some assistance for those who deal with Real Estate Mortgage Investment Conduits (REMICs). However, as welcome as this step is, it is not likely to prove a giant leap forward – helpful but not precedent-shattering.

The new final Treasury Regulations[1] clarify how the rules for REMICs apply to commercial mortgage loans. While the final regulations are welcome, and helpful in providing clarity in some situations, they do not provide any inherently new strategies for dealing with problem loans in commercial mortgage-backed securities (CMBS) transactions.

What the New Regulation Does

The new regulation pertains to performing commercial mortgage loans that are not in default, and are not reasonably expected to go into default. The REMIC rules permit only limited modifications of performing loans. The new regulation clarifies that the following types of actions, even when undertaken for performing loans, will not affect the REMIC status of a CMBS transaction:

Partial release of a real property lien, if after the release, the mortgage loan continues to be secured primarily by real property (see below regarding what this means)

Substitution or modification of collateral, credit enhancement or recourse, if after the change, the mortgage loan continues to be secured primarily by real property (see below regarding what this means)

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These are in addition to the following events, that were already in this category:

- **Defeasance,** if that is permitted under the terms of the loan documents, the REMIC has been in existence for at least two years, the defeasance assets are government securities, and the defeasance occurs in the context of a customary transaction, such as selling the real property, and not as part of a program to switch the whole REMIC over to non-real estate collateral
- **Waiver of due-on-sale or due-on-encumbrance clause**
- **Conversion of interest rate,** if that is permitted under the terms of the loan documents
- **Assumption**

The new regulation also provides clarifying guidance about what it means to say that a loan is secured primarily by real property, which is relevant to the new tests described above.

- **The 80% test.** The REMIC regulations already included the concept that real property securing the loan must be worth at least 80% of the outstanding loan amount. The new regulation clarifies how this 80% is supposed to be determined in the context of a loan modification. The 80% is determined as of the time of the modification. The value can be based on a new appraisal, an update of the original appraisal, the sales price if the property is being sold and the loan assumed, or any other commercially reasonable method.
- **No reduction of real property securing the loan.** As an alternative, the new regulation says that a modified loan will not lose its status as primarily secured by real property as long as the value of the real property securing the loan is at least as great as before the modification. In other words, if the modification does not take away any real property that was securing the loan before the modification, then the loan will continue to be considered primarily secured by real property, even if lots of non-real property collateral and credit enhancement are added, or the real property has declined substantially in value, and no longer represents 80% or more of the loan amount. If the very nature of the modification is such that the real property collateral does not change (or if it changes in a way that has demonstrably more value as collateral), then no appraisal would be needed, and the 80% test would be

irrelevant.

What the New Regulation Does NOT Do

The new regulation does not alter the powers of the servicer under the Pooling and Servicing Agreement (or other transaction documents) for the CMBS transaction. The servicer is still charged with maximizing value for the CMBS investors, according to the specified servicing standard, and will not agree to a loan modification that does not advance the lenders' interests.

The new regulation does not change the servicer's motivations, or the contractual limits on its powers.

If the Pooling and Servicing Agreement requires consultation with, or approval by, another party before a modification is approved, the new regulation will not alter that requirement.

The New Regulation Effectively Creates Safe Harbors

While the new regulation does not break new ground, it will make it easier for parties to accomplish some practical and normal real property transactions. It does this by, effectively, creating safe harbors, which will reduce the cost of completion in some situations.

A. Legal Opinions

The new regulation will make it easier for lawyers to give opinions in some situations. The CMBS transaction documents often provide that various transactions, including loan modifications, cannot be undertaken unless the servicer and trustee receive a legal opinion that the transaction will not cause the CMBS trust to lose its status as a REMIC. For some sorts of transactions, even though people thought they would not result in a loss of REMIC status, that was hard to prove. This made it hard for lawyers to opine about the issue. The new regulation creates safe harbors within which legal opinions will be more straightforward.

For example, in the past parties may have negotiated for a change in the credit enhancement for a loan, but when it came time for the REMIC opinion to be rendered, the lawyers would struggle with how to prove that, as a matter of law, this was an insignificant change, such that the loan would not be considered a new loan for purposes of the REMIC law. At best, the opining law firm would rely on expansive legal reasoning and analysis to reach its conclusion, which would be couched in qualified terms. With this regulation, the law firm's job is more like checking off the requisite elements.

B. Valuation

As noted above, the new regulation also creates some options for demonstrating that a modified loan continues to be primarily secured by real property. These include reliance on an old appraisal, if it is updated, as well as other commercially reasonable valuation methods.

Also, the new regulation allows the parties to avoid valuation altogether if, by the nature of the transaction itself, the value of real property that secures the loan is not being diminished. This would be the case where no real property is being released from the lien of the loan. Even if other types of property and credit enhancement are being added to a point where the real property is relatively insignificant, the transaction will not destroy the status of the loan as being primarily secured by real property. This is important in a time when the value of real property has plummeted.

Thus, the effect of these regulatory improvements will be to facilitate the completion of some transactions that likely were always thought to be consistent with REMIC status, by giving the parties and their lawyers the tools to prove that this is the case.

[1] Final Regulation issued with an effective date of September 16, 2009, modifying portions of Treasury Regulations § 1.860G-2 (Federal Register, September 16, 2009, pages 47436 - 47439.)

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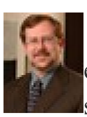

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