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U.S. Department of the Treasury and IRS Issue New Guidance Allowing for Easier Restructuring of CMBS Loans

Recent filings for bankruptcy protection by such high profile borrowers as General Growth Properties, Inc. have highlighted the need for a more flexible and proactive approach to restructuring securitized loans. With a projected $150 billion in commercial-mortgage-backed securities (CMBS) loans coming due in the next few years, the potential for wide-scale defaults by owners of commercial property is a very real prospect. In the present economic climate where credit is tight, many borrowers will not be able to refinance these securitized loans when they come due.

Mortgages securing CMBS are often held in real estate mortgage investment conduits (REMICs), intended to be pass-through vehicles for tax purposes. Existing rules pose a risk of substantial tax penalty (a REMIC being taxed as a corporation) if a commercial mortgage loan is significantly modified before a default has occurred or is reasonably foreseeable. In order to avoid such consequences, holders and servicers have interpreted this standard to require that they not discuss or negotiate potential modifications until a loan is not performing or default is imminent. Borrowers with mortgage loans that are covering debt service but cannot be refinanced under current lending standards have been unable to discuss or negotiate loan modifications in advance of maturity, increasing the probability of a default on a loan at maturity and foreclosure on the mortgaged property or a bankruptcy filing to attempt a forced restructuring of a mortgage loan.

I. New U.S. Department of the Treasury and Internal Revenue Service Guidance

Last week, responding to industry requests, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) liberalized the rules for restructuring mortgages that are held by REMICs. In particular, the Treasury finalized regulations that expand the list of permitted loan modifications that will not jeopardize a REMIC's qualification status. The expanded list allows certain changes in collateral, guarantees, and credit enhancement of an obligation, and changes to the recourse nature of an obligation. These changes are permitted so long as the obligation continues to be principally secured by an interest in real property.

At the same time, the IRS published Rev. Proc. 2009-45, which allows servicers and holders to modify loans that are held in a REMIC and are not in default, but for which either the servicer or holder *reasonably believes* that there is a significant risk of default. This reasonable belief must be based on "a diligent contemporaneous determination of that risk." However, a servicer or holder can hold a reasonable belief that there is a significant default risk, even if such default is a year or more away. Indeed, "[t]here is no maximum period ... after which default is per se not foreseeable."

Rev. Proc. 2009-45 applies to all CMBS loan modifications since January 1, 2008, so long as the following four criteria are satisfied:

> (1) the loan security is not a residence of fewer than five dwelling units, one of which is the borrower's principal residence (last year, the IRS granted relief for the restructuring of residential mortgages in Rev. Proc. 2008-28);

(2) at the end of the REMIC's initial three months, no more than 10% of the REMIC's stated principal of the total assets may be overdue by 30 days or more, or may be loans for which a default is reasonably foreseeable;

(3) the servicer or holder must reasonably believe there is a significant risk of default under the unmodified loan; and

(4) the servicer or holder must reasonably believe that the loan as modified presents a substantially reduced risk of default.

II. Potential Issues and Conflicts

The new Treasury and IRS guidance will help many borrowers and REMICs who were previously unable to modify their mortgages. However, the benefits to the other parties involved in a loan—servicers, holders of different CMBS tranches, junior mortgage and mezzanine lenders, and potential purchasers of CMBS loans—are not as clear-cut. In the event of a default, holders of senior CMBS series are likely to be repaid, while junior participants may be at risk. With restructurings permitted in advance of an actual or imminent default, however, the holder of a senior interest may have to wait longer to recover on its investment, while a more junior interest holder may recover more on its investment.

While Rev. Proc. 2009-45 may allow a loan to be modified if the modification would substantially reduce the risk of default, servicers and holders will still be bound by the requirements and standards in their applicable pooling and servicing agreements and related intercreditor and/or participation agreements, which may limit their ability to act when the interests of the holders of different series of CMBS are in conflict. In addition, buyers of CMBS will have to assess the risk that loan terms may be modified well in advance of maturity or default, affecting investment return.

III. Impacts

The government hopes that the new guidance will provide flexibility to alleviate a potential wave of defaults on CMBS loans and provide greater stability for the CMBS market. Servicers of REMIC loan pools will, however, need to navigate such restructurings carefully, so as to satisfy duties to all CMBS interest holders. Potential CMBS purchasers will also need to consider the greater possibility that the underlying loans may be modified prior to maturity.

Ropes & Gray's Real Estate, Debt Finance, Bankruptcy and Business Restructuring, and Tax groups have significant experience in advising on CMBS and other securitized financing arrangements. Ropes & Gray represents clients ranging from borrowers to purchasers of mortgage and mezzanine loans and CMBS and other asset-backed securities. If you have any questions about CMBS and other securitized financings, please do not hesitate to contact your regular Ropes & Gray attorney.

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