Major Changes to REMIC Rules Relating to Modifications to Loans Secured by Commercial Property—A Mixed Bag

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The Department of the Treasury recently issued important new rules addressing the types of modifications that may be made to loans held by Real Estate Mortgage Investment Conduits (REMICs). First, the Treasury released final REMIC regulations that could significantly change the types of modifications permitted to be made to loans held by a REMIC. Second, the Treasury issued Revenue Procedure 2009-45, which clarifies the servicer's analysis when allowing for certain modifications, relying on the "reasonably foreseeable default" exception contained in the REMIC Regulations. Although these changes could be important to both servicers and borrowers because, standing alone, they would now allow modifications to loans that previously have been prohibited, they may be circumvented in many cases by the Pooling and Servicing Agreement (the PSA). Additionally, these changes also may have the unintended consequences of prohibiting certain lien releases that were allowed under the previous REMIC rules.

NEW REMIC REGULATIONS

The newly issued REMIC Regulations affect modifications to loans that are made on or after September 16, 2009. These "final" REMIC Regulations significantly expand the allowable modifications to a qualified mortgage. Nevertheless, some of the allowable modifications under the "final" regulations may still be prohibited by the PSA, which limits servicer's abilities to modify loans in many respects.

Section 860D(a)(4) of the Internal Revenue Code (the Code) requires that substantially all of the assets of a REMIC must consist of qualified mortgages and permitted investments as of the close of the third month beginning after the startup day of the REMIC and at all times thereafter. A "qualified mortgage" is "any obligation which is principally secured by an interest in real property."

If an obligation is significantly modified (as analyzed under Section 1001 of the Code) and the modified obligation is not a "qualified replacement mortgage," then the modified obligation will not be a "qualified mortgage" and the deemed disposition of the unmodified obligation will be a "prohibited transaction" subject to federal tax and could cause the REMIC to lose its REMIC status.

The REMIC Regulations contain specific exceptions, however, providing that even certain modifications that are significant modifications under Section 1001 of the Code will not result in a deemed exchange for REMIC purposes. The "final" REMIC Regulations add to these exceptions and are discussed below, but now require a "retesting" of whether the obligation remains principally secured in certain circumstances.

LIEN RELEASES AND MODIFICATIONS TO COLLATERAL

Old Rule. A REMIC could not release, substitute, add, or otherwise alter a significant amount of the collateral for an obligation, unless the modification was "occasioned by a default or reasonably foreseeable default" or pursuant to a defeasance.

New Rule. The "final" Regulations now require a "retesting" to determine if the loan remains principally secured after any lien release, except when the lien release occurs pursuant to a defeasance. In addition, a REMIC can now release, substitute, add, or otherwise alter any portion (including a substantial portion) of the collateral for, guarantee on, or other form of credit enhancement contract for an obligation if the obligation continues to be principally secured (as defined below) by an interest in real property.

DEFINITION OF PRINCIPALLY SECURED

The loan must be "retested" to determine if it remains principally secured by an interest in real property. There are two tests for determining whether or not an obligation is principally secured by an interest in real property.

(1) The fair market value of the interest in real property securing the obligation, determined as of the date of the modification, must be at least 80 percent of the adjusted issue price of the modified obligation, determined as of the date of the modification.

If, as of the date of the modification, the servicer reasonably believes that the obligation satisfies the test, then the obligation is deemed to do so. A reasonable belief does not exist, however, if the servicer actually knows, or has reason to know, that the test is not satisfied. For these purposes, a servicer must base a reasonable belief on:

(A) A current appraisal performed by an independent appraiser;

(B) An appraisal that was obtained in connection with the origination of the obligation and, if appropriate, that has been updated for the passage of time and for any other changes that might affect the value of the interest in real property;

(C) The sales price of the interest in real property in the case of a substantially contemporary sale in which the buyer assumes the seller's obligations under the mortgage; or

(D) Some other commercially reasonable valuation method.

The Supplement to the "final" Regulations provides the following example:

For purposes of retesting with respect to alterations to real property collateral, the transaction causing the alteration is looked at in its entirety in determining the value of the real property collateral. For example, if, as part of an overall plan to make improvements to real property collateral that secures a mortgage loan, a borrower demolishes an existing building and constructs a new building on that real property, the fair market value of the real property collateral is determined by taking into account both the demolition of the existing building and the construction of the new building.

(2) If the first test is not satisfied, the fair market value of the interest in real property that secures the obligation immediately after the modification must equal or exceed the fair market value of the interest in real property that secured the obligation immediately before the modification.

This test must be established by a current appraisal, an original (and updated) appraisal, or some other commercially reasonable valuation method, and the servicer must not actually know, or have reason to know, that this test is not satisfied.

The following example from the "final" Regulations illustrates the principally secured tests:

Facts: S services mortgage loans that are held by R, a REMIC. Borrower B is the issuer of one of the mortgage loans held by R. The original amount of B's mortgage loan was $100,000, and the loan was secured by real property X. At the time the loan was contributed to R, property X had a fair market value of $90,000. Sometime after the loan was contributed to R, B experienced financial difficulties such that it was reasonably foreseeable that B might default on the loan if the loan was not modified. Accordingly, S altered various terms of B's loan to substantially reduce the risk of default. The alterations included the release of the lien on property X and the substitution of real property Y for property X as collateral for the loan. At the time the loan was modified, its adjusted issue price was $100,000. The fair market value of property X immediately before the modification (as determined by a commercially reasonable valuation method) was $70,000, and the fair market value of property Y immediately after the modification (as determined by a commercially reasonable valuation method) was $75,000.

Analysis: The modified loan does not satisfy the first test of this section because property Y is worth less than $80,000 (the amount equal to 80 percent of the adjusted

issue price of the modified mortgage loan). The modified loan, however, satisfies the second test because the fair market value of the interest in real estate (real property Y) that secures the obligation immediately after the modification ($75,000) exceeds the fair market value of the interest in real estate (real property X) that secured the obligation immediately before the modification ($70,000). Accordingly, the modified loan continues to be principally secured by an interest in real property.

CHANGES FROM NONRECOURSE TO RECOURSE AND VICE VERSA

Old Rule: With limited exceptions, changes in the nature of an obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) and vice versa are significant modifications.

New Rule: The "final" Regulations provide that changes in the nature of an obligation from nonrecourse to recourse and vice versa are permitted as long as the obligation continues to be principally secured by an interest in real property (using the tests described above).

REVENUE PROCEDURE 2009-45

Certain loan modifications are not significant modifications for purposes of the REMIC regulations, even if they are significant modifications under Section 1001 of the Code. Specifically, if a change in the terms of an obligation is "occasioned by default or a reasonably foreseeable default," the change is not a significant modification for purposes of the REMIC regulations. This Revenue Procedure describes how this exception may be used. It applies to all modifications occurring on or after January 1, 2008.

Old Analysis: To make modifications to an obligation that would otherwise be significant modifications, the modifications must be "occasioned by default or a reasonably foreseeable default." In analyzing this, all the facts and circumstances of each case are taken into account, but generally it is required that the default be imminent or not performing (as noted in the Revenue Procedure).

New Analysis: If, based on all the facts and circumstances, the holder or servicer reasonably believes that there is a significant risk of default upon maturity of the loan or at an earlier date and that the modification substantially reduces such risk, a modification may be made.

This reasonable belief must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the borrower if the REMIC or servicer neither knows nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is per se not foreseeable. For example, in appropriate circumstances, the REMIC or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, the REMIC or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

EXAMPLE FROM REVENUE PROCEDURE 2009-45

Facts: As part of its business, S services mortgage loans that are held by R, a REMIC. Borrower B is the issuer of one of the mortgage loans held by R. B's mortgage loan is non-amortizing, and thus the entire principal amount is due upon maturity. The real property securing B's mortgage loan is an office building. All of B's required payments on the mortgage loan have been timely, and the loan is not scheduled to mature for another 12 months. B expects that in order to repay the loan when it matures, B will have to refinance the maturing mortgage loan into a newly issued mortgage loan. There are factors, however, that indicate that refinancing options may be unavailable to B at the time the mortgage loan matures. These factors include either or both of the following: current economic conditions in the relevant credit markets, and the current market value of the real property securing the loan. B provides a written factual representation to S showing that B will probably not be able to repay or refinance the mortgage loan at maturity. S neither knows, nor has reason to know, that the representation is false.

Based on all the facts and circumstances and a diligent contemporaneous determination, S reasonably believes that, if the loan to B is not modified, there is a significant risk of default by B upon maturity of the mortgage loan. Therefore, S, and B agree to modify the mortgage loan by extending its maturity and increasing the interest rate. S reasonably believes that this modification reduces the risk of default. The modification is a significant modification under Section 1.1001-3(e) of the Treasury Regulations. The

modification occurs after the effective date of this revenue procedure.

Analysis: S reasonably believed that the pre-modification loan presented a significant risk of default and that the modification substantially reduced that risk. Accordingly, the modification is within the scope of this revenue procedure.

CONCLUSION

These changes and clarifications may help the industry better manage collateralized debt and provide more clarity to servicers in a time when modifications to loans are especially needed. Undoubtedly, however, these changes bring new issues to the forefront. For example, lien releases that the servicer is contractually bound to deliver (i.e., a unilateral option) where the loan fails to meet either of the two new principally secured tests. Although efforts are currently underway to convince the IRS and the Treasury to correct this apparently unintended result, until that correction comes, some servicers may find themselves with an unenviable decision between violating the "final" REMIC regulations or breaching a contractual provision with a borrower and thus exposing the REMIC to litigation. In addition, lien releases that previously were allowed because the loan was either in default or default was reasonably foreseeable, will now be limited to those that meet the principally secured test. Lastly, many of the PSAs that govern the servicing of REMICs contain provisions that are so restrictive many of the possible advantages that could be reaped by the "final" regulations will ultimately be dwarfed. While these new issues may take some time to work themselves out, many borrowers are likely to be knocking at servicer's doors in record numbers trying to take advantage of the new REMIC rules.

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