Are Commercial Real Estate & Debt Workouts Finally Ready For Prime Time?

[This is the Dawn of New Creative Financing Empires; New 2010 Tax Regulations Support the Ballooning Commercial Workout with Revenue Procedure 2010-30]

By Richard Ivar Rydstrom, Esq., LL.M.
Chairman Commercial Workout Group™, CMIS Mortgage Coalition
Tel: 949-678-2218 | Rich@CommercialWorkoutGroup.Com
www.CommercialWorkoutGroup.Com

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If you have ever wondered how and why certain rules come to exist, take a look behind the new tax Revenue Procedure 2010-30 to understand the 'thinking' behind commercial modifications and debt

restructurings. Just as commercial real estate workouts are set to balloon, Revenue Procedure 2010-30 was issued to describe the circumstances under which the Internal Revenue Service will not challenge a mortgage loan held by a real estate mortgage investment conduit (a "REMIC") as other than a "qualified mortgage" on the grounds that the mortgage loan fails to be principally secured by an interest in real property for purposes of section 860G(a)(3)(A) of the Internal Revenue Code and § 1.860G-2(a)(8) of the Income Tax Regulations following a release of a lien on an interest in real property that secures the mortgage loan. Revenue Procedure 2010-30 will appear in IRB 2010-36 dated Sept. 7, 2010 and apply to release of liens on interests in real property held by REMICS on or after September 16, 2009.

If this movie sounds familiar, it should. On September 16, 2009, TD 9463 (26 CFR Parts 1 and 602) took effect. TD 9463 **expanded the list of permitted exceptions** under Section 1.860G-2(b)(3) to include (1) changes in **collateral, guarantees, and credit enhancement** and (2) clarified when a release of a lien on real property securing a qualified mortgage does not disqualify the mortgage. Although these final regulations (TD 9463) resolved and clarified many issues for Modifications of commercial mortgages held by Real Estate Mortgage Investment Conduits (REMICs), the IRS and Treasury continued to study commentators' recommendations and solicited input concerning comments on whether additional guidance may be appropriate on Modifications of Commercial Mortgage Loans Held by an Investment Trust (Notice 2009-79).

Last year, TD 9463, expanding on the work of Rev. Proc. 2009-45, paved the way for borrowers, special servicers, attorneys, and brokers to start the workout process **before default or upon a reasonably foreseeable default,** to afford the servicer more chances of fashioning a workout plan without invoking fear of violating REMIC, contract, or covenant restrictions, and without unnecessary costs, fees, or regulation restrictions (See **New Final Regulations Resolve Open Issues for Modifications of Commercial Mortgages Held by REMICs –But Modifications Held by Investment Trusts Remain Unanswered Pending Comments** [TD 9463, Rev. Proc. 2009-45, Notice 2009-79] By: Richard Ivar Rydstrom, Esq.; http://www.commercialworkoutgroup.com/COMMERCIAL_MODS_REGS_ARTICLE_9-16-09_A_1__1_.pdf). For illustration, TD 9463 concluded in part as follows:

1. The Lien Release Rule - The final regulations clarify that a release of a lien on real property that does not result in a significant modification under §1.1001-3 (***for example, a release or substitution of collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan***) is not a release that disqualifies a mortgage loan, so long as the mortgage continues to be principally secured by real property after giving effect to any releases, substitutions, additions, or other alterations to the collateral. Similarly, the final regulations clarify that a lien release occasioned by a default or a reasonably foreseeable default is not a release that disqualifies the mortgage, so long as the principally-secured test continues to be satisfied.

To satisfy a lender (in a modification), the borrower may have to enhance the value and quality of the security for the loan (collateral) by adding, replacing or pledging other assets as collateral. Examples may include substitute collateral that consists of other real property, or Government Securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a1)); Stripped bonds and coupons. The term qualified mortgage includes stripped bonds (1286(e)(1) and stripped coupons (1286(e) (2) and (3)) if the bonds would have been qualified mortgages.

2. The Requirement to Retest the Collateral Value - The TD required a retesting with respect to a lien release that is not a significant modification for purposes of §1.1001-3 (for example, a release of real property collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan). Here as well, the principally secured test is satisfied if either the 80–percent test is satisfied based on the current value of the real property securing the mortgage or the value of the real property collateral after the modification is no less than the value of the real property collateral immediately before. In addition, to provide a more flexible standard for changes that do not decrease the value of real property securing the mortgage loan, the final regulations provide an alternative method for satisfying the principally secured test. For these types of changes (***for example, a change from recourse to nonrecourse, or vice versa***), the final regulations provide that a modified mortgage loan continues to be principally secured by real property if the fair market value of the interest in real property that secures the loan immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the loan immediately before the modification. This alternative test is consistent with the general rule that a decline in the value of collateral does not cause a mortgage loan to cease to be principally secured by real property. The final regulations provide an example to illustrate the application of this alternative method for satisfying the principally secured test. The final regulations also require retesting with respect to a lien release that is not a significant modification for purposes of §1.1001-3 (for example, a ***release of real property collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan***). Here as well, the principally secured test is satisfied if either the 80–percent test is satisfied based on the current value of the real property securing the mortgage or the value of the real property collateral after the modification is no less than the value of the real property collateral immediately before.

If the loan docs allowed the release of certain property securing the loan, such as a ground lease, pad, or parking lot, when the borrower reached certain predefined lease-up goals, or valuations, as long as the fair market value continued to meet the 80% principally secured test immediately after the release, the loan would continue to be a qualified mortgage. In cases where the valuations were lower, and the post-release valuation was below the 80% principally secured test, it would not be permitted under the regulations.

3. The Appraisal Requirement - TD 9463 in pertinent part states: In response to these comments and to make the retesting requirement more consistent with the current rules for satisfying the 80-percent test at the startup day, the final regulations provide that the principally-secured test will be satisfied if the servicer reasonably believes that the modified mortgage loan satisfies the 80-percent test at the time of the modification. The final regulations provide that a servicer must base *a reasonable belief upon a commercially reasonable valuation method*. The final regulations set forth a nonexclusive list of commercially reasonable valuation methods that can be used by servicers for retesting purposes. These same commercially reasonable methods can be used under the alternative test to establish that the value of the real property collateral immediately after the modification is no less than the value of the real property collateral immediately before it.

4. Changes in the Nature of an Obligation from Nonrecourse to Recourse - TD 9463 states: The final regulations clarify that changes in the nature of an obligation from *nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) are permitted so long as the obligation continues to be principally secured by an interest in real property*.

In the event the borrower elects a pre-defined assumption right (contained in the loan documents), but the lender is not comfortable with the credit, it may require a recourse guaranty. This change from nonrecourse to recourse is permitted so long as the obligation continues to be principally secured by an interest in real property.

5. Investment Trusts: TD 9463 in pertinent part also deferred to further comment, that changes to the terms of commercial mortgage loans held by investment trusts may raise issues as to whether a “power to vary” is present.

BACKGROUND OF COMMERCIAL MORTGAGE LOANS

Negative Tax Consequences of Modifications (Release of Liens) That Violate Tax Rules/Regulations:

Generally, when a lien is released or a mortgage is modified in whole or part (as a prohibited transaction), a 100% tax may be assessed for violation of the REMIC requirements, or on the gain realized from the disposition of the prior obligation, or on the income from the prohibited transaction (from the modified obligation) (IRC 860 et seq.) Generally, Internal Revenue Code (IRC) section 860F(a)(1) imposes a tax on REMICs equal to 100 percent of the net income derived from “prohibited transactions.” The disposition of a qualified mortgage is a prohibited transaction unless the “disposition [is] pursuant to—(i) the substitution of a qualified replacement mortgage for a qualified mortgage . . . , (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the REMIC, or (iv) a qualified liquidation.” Section 860F(a)(2)(A).

Revenue Procedure 2010-30 explains that a single commercial mortgage loan is secured by liens on multiple interests in real property. The terms of a commercial mortgage loan typically allow the borrower to obtain a release of a lien if certain conditions are satisfied. In a limited number of cases, the borrower may obtain the release of a lien at will. More often, a <u>lien release is conditioned on a requirement that the borrower pay down the principal</u> on the loan by a prescribed amount. If the mortgage loan is secured by multiple properties, the terms of the obligation may provide that certain properties may be sold and the sale proceeds applied to pay down the loan. In general, <u>the payment required must be no less than the net proceeds from a sale of the property</u> or no less than an amount that is calculated by a predetermined formula.

SCOPE OF NEW RULE:

Section 5 of Revenue Procedure 2010-30 defines the scope of this new rule as follows:

> .01 This revenue procedure applies to a release of a lien on an interest in real property that secures a mortgage loan held by a REMIC in circumstances in which §§ 1.860G-2(b)(7)(ii) and 1.860G-2(b)(7)(iii) are not satisfied. A release of a lien that is effected by either a grandfathered transaction described in section 5.02 of this revenue procedure or by a qualified pay-down transaction described in section 5.03 of this revenue procedure qualifies for the benefits of this revenue procedure.
>
> .02 A grandfathered transaction is any release of a lien on an interest in real property that satisfies the following two criteria—
>
> (1) The lien release is not a modification for purposes of § 1.1001–3(c) because it occurred by operation of the terms of the debt instrument (including a lien release pursuant to the exercise of a unilateral option of the borrower within the meaning of § 1.1001-3(c)(3)); and
>
> (2) The terms providing for the lien release are contained in a contract that was executed no later than December 6, 2010**.**
>
> .03 A "qualified pay-down transaction" is a transaction in which a lien is released on an interest in real property and which includes a payment by the borrower resulting in a reduction in the adjusted issue price of the loan by a "qualified amount" as described in section 5.04 of this revenue procedure.
>
> .04 A "qualified amount" is an amount that is equal to or greater than at least one of the following:
>
> (1) the sum of —
>
> (a) the net proceeds available to the borrower from an arms-length sale of the property to an unrelated person;
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> (b) the net proceeds from the receipt of a condemnation award with respect to the property; and
>
> (c) in a case to which (a) or (b) above applies, the net proceeds from the receipt of an insurance or tort settlement with respect to the property;
>
> (2) an amount that is determined under the loan agreement and that equals or exceeds the product of —
>
> (a) the adjusted issue price of the obligation at the time of the lien release; multiplied by

(b) a fraction equal to the fair market value at origination of the released interest, divided by the aggregate fair market value at origination of all of the interests in real property that secured the loan immediately before the lien release;

(3) the fair market value (at the time of the transaction) of the interest in real property the lien on which is released, plus the amount of any tort or insurance settlement that is expected to be, or has been, received with respect to the property and that is not reflected directly or indirectly in the property's fair market value at the time of the transaction;

or

(4) an amount such that, immediately after the transaction, the ratio of the adjusted issue price of the loan to the fair market value of the interests in real property securing the loan is no greater than what that ratio was immediately before the transaction.

.05 The term "net proceeds" for purposes of section 5.04(1) of this revenue procedure means the amount realized for purposes of computing gain or loss under section 1001.

REMICS & SAFE HARBOR DISCUSSION:

Section 3 of Revenue Procedure 2010-30 explains REMICS in pertinent part only, as follows:

.01 Commercial mortgage loans are commonly pooled and held in REMICs, securitization vehicles governed by sections 860A through 860G.

.02 Section 860D(a)(4) provides, in pertinent part, that an entity qualifies as a REMIC only if, as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of the entity's assets consist of qualified mortgages and permitted investments. This asset test is satisfied if the entity owns no more than a *de minimis* amount of other assets. <u>See</u> § 1.860D–1(b)(3)(i). As a safe harbor, the amount of assets other than qualified mortgages and permitted investments is *de minimis* if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the entity's assets. Section 1.860D–1(b)(3)(ii).

<u>WHAT IS A MODIFICATION?</u>

.05 Section 1.1001–3(c)(1)(i) defines a "modification" of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001–3(e) governs which modifications of debt instruments are "significant." Under § 1.1001–3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.06 Under §1.860G–2(b), related rules apply to determine REMIC qualification. Except as specifically provided in §1.860G–2(b)(3), if there is a significant modification of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. <u>See</u> § 1.860G-2(b)(1). For this purpose, the rules in § 1.1001–3(e) determine whether a modification is "significant." See § 1.860G-2(b)(2). Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of loans held by the entity may terminate the entity's qualification if the modifications cause less than substantially all of the entity's assets to be qualified mortgages.

.07 Certain loan modifications are not significant modifications for purposes of § 1.860G–2(b)(1), even if the modifications are significant under § 1.1001–3. Section 1.860G–2(b)(3) contains a list of modifications that are expressly permitted without regard to the section 1001 modification rules.

WHAT IS A "MORTGAGE LOAN" "PRINCIPALLY SECURED BY AN INTEREST IN REAL PROPERTY"?

Section 4 of Revenue Procedure 2010-30 explains the principally secured by an interest in real property test in pertinent part only, as follows:

.01 A mortgage loan is a qualified mortgage only if it is principally secured by an interest in real property. Section 860G(a)(3)(A).

WHAT IS THE 80% TEST?

.02 In general, for purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property only if it satisfies the "80–percent test" set forth in § 1.860G–2(a)(i). (Section 1.860G–2(a)(ii) contains an alternative test.)

.03 Under the 80–percent test, an obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation—

(1) Was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated; or

(2) Is at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC.

.04 In the absence of a lien release or certain other transactions that alter a legal right or obligation either of a REMIC or of the issuer of a mortgage loan that is held by the REMIC, the mortgage loan is not retested to determine whether the current value of its real estate collateral still satisfies the principally secured test.

.05 Under § 1.860G–2(a)(8), if a REMIC releases its lien on an interest in real property that secures a qualified mortgage, the mortgage ceases to be a qualified mortgage on the date the lien is released unless either—

(1) The mortgage is defeased in the manner described in § 1.860G–2(a)(8)(ii); or

(2) The lien is released in a modification that satisfies both of the following criteria:

(i) The modification either is not a significant modification as defined in § 1.860G–2(b)(2) or, under one of the exceptions in § 1.860G–2(b)(3), is not treated as a significant modification for purposes of § 1.860G–2(b)(1); and

(ii) Following the modification, the obligation continues to be principally secured by an interest in real property, as determined by § 1.860G–2(b)(7).

.06 Section 1.860G–2(b)(7) provides that, for purposes of §§ 1.860G–2(a)(8)(i), 1.860G–2(b)(3)(v), and 1.860G–2(b)(3)(vi), an obligation continues to be principally secured by an interest in real property following a transaction that alters the legal rights of the parties only if, as of the date of the transaction, the obligation satisfies either paragraph (b)(7)(ii) or paragraph (b)(7)(iii) of § 1.860G–2.

<u>APPRAISALS AND VALUATIONS ARE KEY!</u>

.07 An obligation satisfies § 1.860G–2(b)(7)(ii) if the fair market value of the interest in real property securing the obligation, determined as of the date of the modification, is 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 criterion in the preceding sentence, then the obligation is deemed to do so. A reasonable belief does not exist if the servicer actually knows, or has reason to know, that the criterion is not satisfied. For purposes of § 1.860G–2(b)(7)(ii), a servicer must base a reasonable belief on—

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

(2) 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;

(3) 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

(4) Some other commercially reasonable valuation method.

.08 An obligation satisfies § 1.860G–2(b)(7)(iii) if § 1.860G–2(b)(7)(ii) is not satisfied but the fair market value of the interest in real property that secures the obligation immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the obligation immediately before the modification. The criterion in the preceding sentence 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 the criterion in the preceding sentence is not satisfied.

.09 Under § 1.860G–2(a)(5), obligations secured by interests in real property include mortgage pass-through certificates guaranteed by GNMA, FNMA, FHLMC, or CMHC (Canada Mortgage and Housing Corporation) and other investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC, provided that the investment trust is classified as a trust under § 301.7701–4(c) of the Procedure and Administration Regulations.

.10 Under § 1.860G–2(b)(6), if a REMIC holds as a qualified mortgage a pass-through certificate or other investment trust interest of the type described in § 1.860G–2(a)(5), the modification of a mortgage loan that backs the pass-through certificate or other interest is not a modification of the pass-through certificate or other interest unless the investment trust structure was created to avoid the prohibited transaction rules of section 860F(a). Analogously, unless a substantial purpose of the trust structure was to avoid the restrictions imposed by § 1.860G–2(a)(8) and

§ 1.860G–2(b), the release of a lien on an interest in real property that secures an obligation held by the trust does not cause § 1.860G–2(a)(8) automatically to disqualify the obligation.

.11 When there are significant declines in commercial real estate property values, properties that secure commercial loans may fall in value to an amount below the 80 percent threshold. The borrower may be in default on its obligation or default may be reasonably foreseeable. In these instances, the servicer may work with the borrower to avoid default.

.12 In the preamble to final regulations published September 16, 2009 (the "Final Regulations"), the Service noted that, although a qualified mortgage must be principally secured by an interest in real property, a release pursuant to the terms of a mortgage obligation is not a release that disqualifies the mortgage if the mortgage continues to be principally secured by real property after giving effect to any releases, substitutions, additions, or other alterations to the collateral. In addition, the preamble explains that a lien release occasioned by a default or reasonably foreseeable default would not disqualify a mortgage if the principally secured test continues to be satisfied. See T.D. 9463, 74 FR 47436-01.

Conclusion:

The time is now to engage commercial workouts en-masse. Brokers should contact owners of commercial buildings and banks holding loans or portfolios, and provide valuable workout assistance. As commercial defaults continue to grow in this environment of declining valuations (or negative equity) with the current anemic credit markets, many commercial owner borrowers will not be able to refinance or satisfy the payment due at maturity (or the conditions of refinance). Lack of available funds for principal pay-down workouts is limiting owner borrowers from fashioning acceptable workouts. The accepted model of expecting to use the proceeds from refinancing to satisfy the principal balance due at maturity is facing great challenges and causing defaults, whether or not sufficient cash flow (ROI) can satisfy the existing debt service. Creative finance solutions are now paramount. Owner borrowers, who do negotiate discounted-payoffs, often cannot satisfy the cash needs of the workout, and need creative debt/equity financiers to close the transaction. With less liquidity and less sales, we need more creative take-out procedures and financing, such as short term bridge equity/debt lenders, transfers to *Valuation Implementation Vehicles™ (VIV™)* into unregulated joint venture vehicles (with borrowers, buyers, investors), (financing to) third party note purchasers with simultaneous forbearance agreements, otherwise liquidations will continue as the servicer's solution of choice. Solutions that allow owner borrowers or buyers to hold commercial property for 5-10 years (after discounted workout solutions or purchases) are likely to realize secure equity and profits. Creative financiers have sufficient market demand opportunities that can build new empires (resulting in new major lenders/banking institutions).

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