CLIENT ALERTS & INSIGHTS

CMBS Update

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Announcement:

On September 15, 2009, the IRS, reacting to the current situation in the credit markets, issued a Revenue Procedure (not yet published) making a significant change to its interpretation of the "REMIC" rules** under § 1.860G-2(b)(3)(i) of the Code of Federal Regulations.

As the credit crisis threatens commercial real estate financing, many developers have encountered the following Catch-22: They cannot negotiate with their special servicer regarding changes to the terms of their CMBS loan until they are in default. Yet, once they have reached that point, they may no longer be in a position to effectively restructure the debt and save the asset.

Now, the rules have changed. Developers may speak to their special servicer, "when the servicer reasonably foresees a significant risk of default in the future." The other rule changes allow modifications to both collateral and loan guarantees. The new rules are effective immediately.

Explanation:

Under the old interpretation of the REMIC rules, the IRS penalized the otherwise tax-free vehicle if a loan was modified by the special servicer prior to a change "occasioned by default or a reasonably foreseeable default." Under IRC 860F(a)(1), the penalty tax was extremely steep - 100% of net income derived from the prohibited transaction. As a result, special servicers could not negotiate with borrowers until there was a default or a default was imminent.

Under the new interpretation of the REMIC rules, a special servicer may speak to the borrower concerning a modification to a loan at any time, provided a few criteria are met, one of which is that, based on the facts and circumstances, the special servicer "reasonably believes that there is a significant risk of a default" at some future date. The foregoing change in interpretation has the potential to exponentially increase the number of CMBS loans that may be restructured in the current market, thus providing much-needed relief to the commercial real estate debt market.

Public Response:

The response by the real estate industry has been overwhelmingly positive. Most believe that this is a significant step in the right direction, and that the changes to the REMIC rules will allow billions of dollars of CMBS debt to be restructured over the next few years.

Possible Negative Consequences:

Some economists suggest that this rule change has the potential of backfiring for two reasons: (1) Opening Pandora's box. The rule changes could lead a massive number of borrowers attempting to refinance their CMBS loans. This will put tremendous pressure on special servicers to properly protect bondholders' interests. (2) Delaying the Economic Recovery. David Loeb of Robert W. Baird & Co., suggested in a September 16, 2009 Research Report that, "these rules might backfire by encouraging the 'pretend and extend' phenomenon, and thereby actually delaying a recovery in the financial and real estate markets." This theory is predicated on the notion that a bad loan is not salvageable, and therefore, any attempt at restructuring is ultimately delaying the inevitable.

Conclusion:

The rule change is only a week old, and it remains to be seen what effect it will have on the real estate industry over the next few months. Overall, though, the response by investors, analysts, and economists has been enthusiastic and hopeful.

** *A Real Estate Mortgage Investment Conduit, or "REMIC," is a type of special purpose vehicle for the pooling of commercial loans and the issuing of commercial mortgage backed securities ("CMBS"). The REMIC, which is set up as a tax-free vehicle, is administered by what is typically known as a "special servicer."*

Additional Information

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