The Dos and Don’ts of REO: Prohibitions on Trade or Business and New Construction

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Background: A REMIC that forecloses on real property might appear to have an advantage over other real estate owners when operating, leasing, and ultimately disposing of that property (referred to as “REO property” once acquired by the REMIC). Unlike a typical developer, a REMIC generally pays no federal income tax on many types of income the REMIC earns from those activities. *See* Tom Biafore, “REMIC Qualification— Why Do We Care?” and “Fear Of The Unknown — The Danger Of Holding Unqualified Assets” in this Guide for a discussion of the significance of REMIC status. Much of the REMIC’S perceived advantage is eliminated, however, by technical rules that restrict the REMIC’s operation and disposition of REO property.

Tax rules require a REMIC to be passive. Once a REMIC acquires REO property, though, it must inevitably take an active (or owner’s) role in the management, operation, and disposition of that property. The foreclosure property rules in the Code and Regulations strike a balance between these two considerations.

“Foreclosure Property”—The Basics: A REMIC only holds “qualified mortgages” or “permitted investments.” One type of “permitted investment” is “foreclosure property”—a statutory and regulatory acknowledgement that from time to time a borrower may default on its obligations under the terms of a qualified mortgage and the REMIC may end up taking title to, operating, and ultimately disposing of that property. Code Section 860G(a)(8) defines “foreclosure property” as property “(A) which would be foreclosure property ... if acquired by a real estate investment trust, and (B) which is *acquired in connection with the default or imminent default* of a qualified mortgage held by the REMIC.” (Emphasis added.) Code Section 856(e) defines “foreclosure property” for purposes of real estate investment trusts (REITs) and limits it to “real property (including interests in real property)” and qualifying personal property (described in detail below).

"Default and Imminent Default." The requirement in Code Section 860G(a)(8)(B) that REO property be "acquired in connection with the default or imminent default of a qualified mortgage held by the REMIC" is an important limitation sometimes overlooked by special servicers. In this regard, the foreclosure property rules take the approach that if the real property was good enough to serve as collateral for the borrower's loan prior to foreclosure, the real property (as is) must be good enough on its own (and without adding additional real property) as foreclosure property for the REMIC following foreclosure. Although some *personal* property related to the business conducted on the REO property can be acquired after the default,[1] *real property* that the REMIC acquires after foreclosure will never qualify as foreclosure property and may not be held by the REMIC.[2] This prohibition can create difficult interpretive issues in connection with non-traditional real property interests. *See* Tom Biafore, "Interests in Real Property – A New Tool for Servicers" in this Guide for a detailed discussion of what amounts to "real property" for these purposes.

To avoid this prohibition, special servicers sometimes propose adding real property collateral (*e.g.,* adjacent property owned by an affiliate of the borrower) prior to but in anticipation of foreclosure. As is often the case, a workaround so obvious and easy to effect is not without peril. While this strategy addresses the technical issue that the newly-added real property did not otherwise secure the borrower's obligation at the time of foreclosure, the borrower's assignment of new real property collateral prior to foreclosure may implicate the Improper Knowledge test, which

[1] Personal property may be acquired after the real property has been acquired through foreclosure if it is "incident" to the real property, even if the personal property was not subject to the mortgagee's lien or even if the personal property was not in existence at the time of foreclosure. Treas. Reg. §1.856-6(b)(2). Personal property will be considered "incident" to a particular item of real property if the personal property is used in a trade or business conducted on the real property or the use of the personal property "is otherwise an ordinary and necessary corollary of the use to which the real property is put." The Regulations give as examples in the case of a hotel such items as "furniture, appliances, linens, china, food, etc."

[2] Proposals to acquire real property after a foreclosure frequently come up where additional interests in real property are needed to operate the foreclosure property (*e.g.,* for parking or other ancillary activities) but where those interests were not part of the security for the borrower's loan at the time for foreclosure. Similarly, when the foreclosure property is comprised of a ground lease the special servicer may consider extending the ground lease's term to make the ground lease more appealing to a potential buyer. While the relative desirability to a potential buyer of a ground lease with a 30 rather three year remaining term cannot be debated, the extended ground lease cannot be (absent some highly unusual circumstance) considered foreclosure property that the REMIC can hold. As a result, the special servicer must resist the temptation to extend the ground lease's term in these situations.

excludes property from the definition of "foreclosure property" if the loan it secures was made or acquired by the REMIC with the intent to foreclose or when the REMIC knew or had reason to know that default would occur ("Improper Knowledge"). The obvious counter argument is that the loan was acquired by the REMIC long before the new real property is being added, but this overlooks another principle discussed elsewhere in the Guide (See Steve Edwards, Tom Biafore and Jennifer O'Connor, "Time for a Change - Modifying Loans Held by REMICs" in the 2016-17 edition of the Servicer Survival Guide for a detailed discussion of what forms of modification of mortgage loans will result in an exchange of the existing loan for a new loan.) If a "substantial amount" of collateral is added to the security for the Loan, the existing loan will be treated as having been exchanged for a new loan. The strategy of adding new real estate collateral to secure a loan before default will therefore work only if the new collateral is not a "substantial amount." If the newly-added real property collateral amounts to a substantial amount of the overall collateral, arguably none of the collateral will qualify as "foreclosure property" as a result of the Improper Knowledge test.[3]

The requirement that a REMIC not acquire an interest in real property other than as a result of the borrower's "default" or "imminent default" cannot be read too broadly. Rather, this rule must be read in conjunction with the other foreclosure property rules (discussed below (*e.g.*, exception to "new construction" on foreclosure property for preparation of tenant space; the completion of construction activity that the borrower started prior to defaulting on its loan etc.)). If the rule that a REMIC can only acquire real property interests as a result of the borrower's loan default was absolute, the rule would make it impossible for the REMIC to enter a new

[3] *But see* the example in Treas. Reg. §1.860G-2(b)(7)((iv), which illustrates the application of the "principally secured" test to a loan where the borrower substituted 100% of the real property collateral at a time when then the borrower's default was "reasonably foreseeable." While the example in the Regulations focused on the application of the "principally secured" test, it seems odd that the example would be included in the Regulations if the result of the collateral substitution in the face of the borrower's "reasonably foreseeable" default would violate the Improper Knowledge test. Perhaps the distinguishing factor is that, in the example, the collateral substitution was intended to reduce the risk of default and work out the loan and was not completed in anticipation of foreclosure. When discussing the Improper Knowledge test, the Regulations under Code Section 856 provide that a trust will not have Improper Knowledge with respect to property on which the trust subsequently forecloses if the trust, in an attempt to avoid default or foreclosure, modified the borrower's loan or advanced additional funds to the borrower prior to foreclosure but during a time when the borrower was in default. Treas. Reg. §1.856-6(b)(3).

lease at the foreclosure property following foreclosure as the lease itself is a new interest in real property that the REMIC would not acquire through foreclosure (*i.e.*, as a result of the borrower's default) but rather as an outgrowth of the REMIC's normal leasing activity of the property following foreclosure. Of course we know it is not the case that a REMIC's lease of foreclosure property results in an impermissible new interest of real property for the REMIC if for no other reason than the Regulations governing the classification of "foreclosure property" contain numerous provisions outlining the scope of the REMIC's permissible leasing activity. If the lease itself was not something that the REMIC could agree to these leasing provisions would have no consequence whatsoever.

With new leases of foreclosure property, we believe the better read of the rules is that rather than creating a new interest in real property, the lease simply encumbers the existing real property interest. In this regard, so long as the new lease does not create for the REMIC a new or greater interest in real property than what the REMIC acquired at the time of foreclosure the new lease should present no REMIC concerns. *(See also* the discussion below on "Impermissible New Construction" in this article. As the new construction would create new interests in real property it would seem unlikely that the Code and Regulations would outline precisely when new construction on foreclosure property is permitted if any such activity would result in a newly constructed interest in real property that the REMIC could not hold in the first instance (as it was not acquired by the REMIC as a result of the borrower's "default or imminent default" but rather as a result of the REMIC's construction activity)).

Foreclosure, Deed in Lieu and Receivership. The Regulations provide leeway in how a REMIC can acquire REO property. The REMIC is not required to conduct a formal foreclosure proceeding. It may acquire the REO property by any means, including bidding on the property at foreclosure or otherwise reducing the property to ownership or possession by agreement (*i.e.*, a deed in lieu) or process of law, after there was a default (or imminent default) on the indebtedness secured by the property.[4] Foreclosure property is treated as having been acquired by the REMIC

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[4] The fact that the property also secures indebtedness owed to other creditors will not make the property ineligible to be foreclosure property.

on the date on which the REMIC acquires ownership of the property for Federal income tax purposes irrespective of any redemption period that the defaulting borrower may enjoy as a matter of state law.

As a result of the Code's limited guidance on how collateral owned by the borrower converts to "foreclosure property" in the hands of the REMIC (*i.e.,* "foreclosure property" is defined simply as the real property that the REMIC acquires "in connection with the default of imminent default of a qualified mortgage held by the REMIC") there is no apparent limit to the means or methods by which the REMIC can "acquire" foreclosure property. Rather, the Code focuses its sole definitional limitation of "foreclosure property" to one fact-- that the REMIC acquired the foreclosure property as a result of the borrower's "default or imminent default." It is possible, therefore, for a REMIC to take title to foreclosure property indirectly by acquiring all the equity of a borrower entity (rather than the collateral property itself through formal foreclosure or a deed in lieu) provided the borrower entity is a "disregarded entity" (*e.g.,* a single member LLC) for tax purposes and the REMIC's acquisition of the equity was a result of the borrower's "default or imminent default."

Depending on elections made by the borrower and the number of members, the IRS will treat the borrower as a corporation, partnership, or as part of the owner's tax return (a "disregarded entity"). Under these rules, an LLC with one member is treated as the same as its owner for all income tax purposes unless that LLC makes the necessary filing (a Form 8832) and elects to be treated as a corporation. As a result of the application of these so-called "disregarded entity" rules, a REMIC that acquires all of the membership interest in a borrower LLC will be deemed to acquire the property owned by that LLC directly. The permissive means by which the Code allows for borrower-owned collateral to convert to "foreclosure property" is limited in its application and should not be read as allowing the REMIC to acquire equity in other entities that are not disregarded entities or acquire equity or other assets as a planning tool rather than as a result of borrower's default or imminent default. *See* for example Tom Biafore and Rex Veal "Property Protection Advancing in CMBS" in this guide for a discussion of the potential hazards to a REMIC acquiring a

mezzanine loan as a planning tool to gain leverage over the borrower in a workout situation.

A REMIC does not acquire ownership of foreclosure property in a typical receivership situation, where the REMIC does not receive any profit or sustain any loss with respect to the property except as a creditor of the mortgagor while the receiver remains in place. In contrast, a REMIC can be considered an owner of REO property if, for example, legal title is acquired upon foreclosure in the name of a nominee for the exclusive benefit of the REMIC, which is the equitable owner of the REO property. The fact that, under local law, the borrower has a right of redemption after foreclosure is also not relevant in determining whether the REMIC has acquired ownership of the REO property.[5] A special servicer should be aware that these rules impact the timing of filings for foreclosure property extensions. *See* Tom Biafore, "Foreclosure Property Extensions – When, What and Where to File" in this Guide for a discussion of the extension rules.

Passive vs. Active -- The Grace Period: Another rule balancing the requirement that a REMIC be passive against the need for the REMIC to operate the REO property is the holding period rule for foreclosure property. The REMIC rules allow the REMIC to hold REO property for only a limited period — through the end of the third taxable year following the year in which the REMIC acquired the related property, although the REMIC may apply for and receive one additional three-year extension of this holding period. By providing a limited period during which the REMIC may hold REO property, the REMIC rules necessarily limit the REMIC's activity with respect to foreclosure property. Unlike other property owners, which may hold that property as long as they desire, a REMIC must dispose of foreclosure property by the end of the related grace period irrespective of the potential market for the property at that time. *See* Tom Biafore, "Foreclosure Property Extensions – When, What and Where to File?" in this Guide for a discussion of the foreclosure property holding period rules.

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[5] Treas. Reg. §1.856-6(b)(1).

Using REO in a Trade or Business: Even if REO property qualifies as "foreclosure property," income generated by the REO property is subject to the 100% tax on prohibited transactions[6] if the REMIC generates active income from the REO property as a result of "(i) the REMIC's use of the REO property *in a trade or business* (except through an independent contractor)." The prohibition against using foreclosure property in a trade or business is an additional limitation on the REMIC's activities with REO property.[7]

In many instances, the nature of prohibited trade or business activity for a REMIC will be obvious — a REMIC cannot operate a business such as a hotel, assisted living facility, golf course or restaurant other than through an independent contractor. In other cases, the trade or business limitation can sneak up on the special servicer. A REMIC could find itself engaged in a trade or business if it actively develops and otherwise holds any REO property for sale to customers through multiple sales of parts of a single REO property. By way of example, a REMIC that forecloses on an apartment building and offers the entire building for sale as part of the REMIC's liquidation strategy will not, absent more, be engaged in a trade or business with respect to the apartment building. If, however, the REMIC elects to convert that same apartment building to condominiums, markets individual condominium units for sale to the eventual inhabitants of the units and holds itself out as the developer of the condominium project, the REMIC will be deemed to be holding the REO property for sale to customers in the ordinary course of its business of developing the condominium project. In this latter case, the apartment building will cease to be REMIC-qualified foreclosure property for purposes of the prohibited transaction rules.

Assessing whether a REMIC is engaged in a trade or business in connection with multiple sales of REO property is a facts-and-circumstances test under which there are no bright-line rules. For example, as we have seen,

[6] Code Section 860F(a)(2)(B).

[7] The limitation in the REMIC rules that provides that only real property that secured the borrower's obligation at the time of foreclosure may be acquired by the REMIC is another form of restriction on a REMIC's ability to carry on a trade or business. By so limiting the real property that a REMIC can acquire, the REMIC rules ensure that the REMIC is not a dealer or active developer of real property that is taking ownership of property that never secured the borrower's obligation under the terms of its loan.

multiple sales of properties can point to trade or business, but there is no requirement in the Code or the Regulations that a REMIC sell all of its REO property in a single transaction to a single purchaser. From a practical perspective, where the REMIC foreclosed on a portfolio of properties located in a number of different areas, it may be unlikely that one buyer would be willing or able to purchase all of the properties.

Outside of the REMIC context, the courts have focused on the taxpayer's motivation for owning a particular piece of real property in deciding whether the taxpayer is a dealer (and therefore engaged in a trade or business). Because that is a factual question, the courts have developed sets of factors to apply in the analysis. The following list set forth in *U.S. v. Winthrop* is one frequently cited example of such a list:

1. The nature and purpose of the acquisition of the property and the duration of the ownership;
2. The extent and nature of the taxpayer's efforts to sell the property;
3. The number, extent, continuity and substantiality of the sales;
4. The extent of subdividing, developing and improving the property that was done to increase sales;
5. The use of a business office and advertising for the sale of the property;
6. The character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and
7. The time and effort the taxpayer actually devotes to the sale of the property.

Other factors to consider when assessing whether a REMIC is engaged in a trade or business as a result of multiple sales of REO property include:

- Reason for Multiple Sales: If the REMIC is proposing to subdivide REO property for multiple sales, the special servicer must assess whether there is a logical reason why different buyers would be interested in different aspects of the REO property. For example, if the REO property is half retail and half office, the fact that one purchaser may be interested only in the retail portion while a different purchaser may be interested only in the office portion should not result in the REMIC being deemed to engage in a trade or business as a result of conducting two separate sales of the REO property to accommodate the fact that the REO property serves two specific needs (*i.e.,* retail and office).

- Purchasing Party: Where the purchasing party is uniquely suited to acquire some but not all of the REO property, it is less likely the REMIC will be deemed to be engaged in a trade or business with respect to the REO property. This would be the case where, for example, an existing (non-borrower) tenant at the REO property (*e.g.,* an operator of a movie theatre, bowling alley, etc.) wants to purchase the space that it currently occupies but not the entire REO property.

- Number of Sales and Preparatory Work: The more sales a REMIC has with respect to a single parcel of REO property, the more likely the REMIC will be considered engaged in a trade or business with that REO property. Similarly, the more preparatory work in which the REMIC must engage to accommodate multiple sales for a single parcel of REO property (signage, tax parcel, site plan, access, utilities, *etc.*), the more likely the REMIC will be deemed to be in the trade or business of developing the REO property.

- Marketing and Appearance: In order to be engaged in a trade or business, the REMIC must be engaged in an activity on a regular basis rather than intermittently or

> sporadically. To the extent that the REMIC: (a) holds itself out as a developer of the REO property, (b) is willing and able to subdivide the existing REO property to accommodate multiple potential buyers, and (c) otherwise gives the outward appearance as a party that is actively developing the REO property rather than simply trying to realize on the security for a defaulted mortgage loan, the more likely the REMIC will be deemed to be in a trade or business with respect to the disposition of the REO property.

Impermissible New Construction: As with the trade or business prohibition, a REMIC is subject to a 100% prohibited transaction tax on the income generated by the REO property as a result of, the REMIC's *construction activities* on the REO property unless,

> (a) the construction consists of the completion of a building[8] where more than 10 percent of the construction of such building was completed before the related loan default became imminent, *and*
>
> (b) any construction more than 90 days after such property was acquired by the REMIC is performed by an independent contractor from whom the REMIC does not derive or receive any income.[9]

Under this rule, a REMIC may not engage in or permit any construction on REO property unless the construction is completing construction that was underway at the time of default (and, here too, the construction must be done by an independent contractor). Renovation of a building, including remodeling the building to reconfigure its layout, is considered "construction." On the other hand, "construction" does not include:

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[8] The term "building" for these purposes generally refers to the building as planned by the borrower at the time of default. Treas. Reg. § 1.856-6(e)(5).

[9] Treas. Reg. § 1.856-6(c). These rules apply only to the REMIC once it has succeeded to the borrower's ownership in the property and has converted loan collateral to foreclosure property. A borrower under the terms of a qualified mortgage held by a REMIC is not subject to the trade or business or new construction prohibitions discussed in this article.

> "(i) the repair or maintenance of a building or other improvement (such as the replacement of worn or obsolete furniture and appliances) to offset normal wear and tear or obsolescence, and the restoration of property required because of damage from fire, storm, vandalism or other casualty,
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> (ii) the preparation of leased space for a new tenant that does not substantially extend the useful life of the building or other improvement or significantly increase its value, even though, in the case of commercial space, this preparation includes adapting the property to the conduct of a different business, *or*
>
> (iii) certain deferred maintenance that the defaulting party failed to perform."[10]

Where the borrower had completed at least 10% of the construction of a building or improvement when the borrower's default became imminent, the REMIC can make modifications to the plans for the building or improvement that increase the direct cost of construction only if –

> "(i) The modifications are required by a federal, state, or local agency, *or*
>
> (ii) Where the building or improvement, *as modified,* was more than 10 percent complete when default became imminent, the modifications are alterations that are either required by a prospective lessee or purchaser as a condition of leasing or buying the property or are necessary for the property to be used for the purpose planned at the time default became imminent."[11]

How this provision can benefit REMICs after taking title to REO property is illustrated by a private letter ruling (PLR 201623007) obtained by this firm. The ruling addressed a situation in which the subject property

[10] Treas. Reg. § 1.856-6(e)(5).

[11] Emphasis added. Treas. Reg. § 1.856-6(e)(3).

was out of compliance with state and local environmental laws as a result of deficiencies in its wastewater treatment facilities. The borrower developed plans to remediate those deficiencies. Owing to financial difficulties, however, the borrower spent only a little more than 10% of the budgeted costs of remediation before default on its loan became imminent. Almost immediately after foreclosure, the REMIC was informed that the proposed remediation was inadequate, that the cost of remediation would be dramatically larger, and that the waste water treatment facilities would have to be moved to another location on the property. After prolonged negotiations, the IRS was convinced that the post-foreclosure remediation project was the same construction project as the one that had commenced before foreclosure and that the increase in costs was a result of modifications required by a state or local agency. It was essential to the IRS's thinking that the project was for the same purpose and that at least 10% of the pre-foreclosure budgeted costs had been incurred.

Aside from the provisions of the Regulations outlined above, there has been limited guidance to taxpayers on the question of what constitutes "construction," leaving many difficult questions of interpretation. For example, how far can the concept of "obsolescence" be pushed? The relevant provision of the Treasury Regulations refers to "repair or maintenance" to "offset obsolescence." Does this also mean that components of a building can be replaced? It would be difficult to imagine that only repairs would be permitted, since something that is obsolete usually cannot be made current merely by repairing or maintaining it. On the other hand, "repair or maintenance" typically refers, at least for income tax purposes, to expenditures that are not capital in nature -- a factor on which the IRS has been particularly focused when considering private letter ruling requests on the issue of impermissible "construction."

Another question is whether "obsolescence" extends to economic obsolescence (*e.g.*, can a component be replaced merely because it is less economical than what a reasonable owner would install today). Again, it seems likely that replacement of a component that is economically obsolete should be permitted, since most items that become obsolete do so primarily because of changes in technology or practices that are intended to make operations more economically efficient. Still, would this extend to

a situation in which, although a component is still perfectly operational, it is not what a prudent operator would install in a new facility?

The exception for the preparation of leased space for a new tenant also raises difficult interpretive issues. Does "leased space" refer only to the existing building or can the REMIC make structural alterations, including alterations that change the footprint of the building? The prohibition against "substantially [extending]the useful life of the building or other improvement or significantly [increasing] its value" suggests that non-structural alterations can be made, because non-structural alterations are less likely to extend the useful life or increase the value of the building or improvement.

The prohibition against "substantially [extending] the useful life of the building or other improvement or significantly [increasing] its value" also raises the issue of which useful life or value must one use in making that determination. A building that was constructed for a single retail tenant has very little value to any other tenant and will typically need to be substantially renovated (or, in some cases, demolished and reconstructed) in order to make it usable by another tenant. If the original tenant has departed (because of a bankruptcy or other default or simply because the original lease expired and the tenant moved to another location), the building arguably has no value or useful life whatsoever unless a new tenant can be identified. Does that mean that the REMIC is prohibited from making any modifications to the building in order to attract a new tenant? Also, what is "substantial" and what is "significant" in this context is left open to interpretation.

The "foreclosure property" definition was added to Code Section 856 in 1974 (a period of distress in the real estate industry) and the accompanying legislative history indicated that Congress was adding the exception for foreclosure property because, without it, a lender that had acquired REO property "may have to take action which is not economically sensible to remain qualified."[12] This suggests that the rules for foreclosure property should not force a REMIC to take (or fail to take) actions that would not be "economically sensible." It would not be economically sensible for a special

[12] Senate Report 93-1357 at 12.

servicer to allow a single-tenant building to remain vacant merely because of a concern that modifying the building in anticipation of a new tenant would significantly increase the building's value and violate this rule. Precisely because the value of the REO property will increase should a new tenant lease be secured is the reason the REMIC is attempting to sign up the new lease in the first place.

Similarly, it is sometimes difficult for the special servicer to determine whether an expenditure is really for a new tenant. Hotel properties are often subject to property improvement plans (PIPs) in order to retain the flag of a hotel. The PIP technically represents the requirements of the franchisor, not the tenant. Moreover, a PIP may include improvements that are difficult to fit within the distinction between preparing space for a new tenant and a complete renovation of an existing facility. Nevertheless, it would again seem odd that the prohibition on construction would require the REMIC to leave the property vacant and without its longtime franchise brand because the brand-mandated PIP was not implemented and the hotel franchisor would not renew the franchise.

The provisions of the Regulations permitting modifications required by a federal, state, or local agency or by a prospective purchaser or lessee are also ambiguous, because they are placed in the portion of the Regulations dealing with how to calculate whether 10 percent of the construction of the building was completed before the related loan default became imminent, rather than as part of the exception to the definition of "construction" (along with the exceptions for repair or maintenance, preparation of leased space, and deferred maintenance). This ambiguity is compounded by the fact that both sections have provisions that deal with the preparation of a building or improvement for a prospective tenant. We think the best reading of these provisions is that modifications required by a federal, state, or local agency will not be treated as construction and that preparation of a building or improvement for an identified tenant or purchaser should also not be treated as construction unless the "preparation" is essentially a renovation of the building or improvement to improve its marketability. There are indications, however, that the IRS does not share this view.

Finally, the Treasury Regulations impose the prohibited transactions tax if "any construction takes place on the property." This raises the issue of whether the REMIC can permit a tenant to engage in construction on the REO property. If the tenant is allowed to undertake the construction under a lease that was in existence prior to the time that the borrower's loan default became imminent, it seems unreasonable to require the REMIC to interfere or object, although a literal reading of the Regulations suggests that the construction activity would not be allowed. This line would blur even where the tenant has such a right, if the tenant is given a credit on its rent for the cost of construction, which could be interpreted as the REMIC indirectly paying for the construction and essentially using the tenant as its agent. In the end, whether or not a tenant has a pre-existing legal right to undertake construction under the tenant's lease, the Regulations technically impose the same restrictions on construction by the tenant as would apply to the REMIC.

These scenarios highlight the high wire act in which the servicer must engage when approving leases that contemplate construction activity not otherwise covered under one of the existing exceptions for tenant improvements, repair and maintenance or the completion of construction that was at least 10% complete. On the one hand, if the borrower continues to perform its obligations until maturity no REMIC concerns arise irrespective of the extent of construction activity required under the lease as the issues only arise should the REMIC take title to the collateral property. On the other, should the borrower default, an open issues exists as to whether the servicer can step in and complete the construction or allow the tenant to go forward with the buildout contemplated in the tenant's approved lease. As servicers cannot exercise prophetic insight at the time the lease is reviewed the situation may prove unworkable. The servicer needs to approve the lease (including the proposed construction activity) to avoid losing the tenant and to prevent the financial fortunes of the collateral from declining. Conversely, if the borrower defaults on its loan obligations, the previously approved construction activity may not be permissible should the REMIC take title to the collateral property. Damned if you do—damned if you don't but what's a servicer to do?

The servicer's approval of a lease that has new construction obligations presents no concerns pre-foreclosure. Rather, it is only in the event of a subsequent loan default when the servicer is anticipating foreclosing on the collateral property where the servicer will encounter these REMIC issues. If the servicer determines that the tenant's construction activity cannot be completed post-foreclosure as the activity was not at least 10% complete prior to the time the borrower's loan default was imminent, the REMIC will either avoid going to title on the collateral property (and will have to seek to recover on the default loan through a loan sale) or will attempt, if possible, to sell the portion of the collateral property on which the construction activity is taking place to the tenant/end user.

Conclusion: A fundamental tension exists in the REMIC provisions that govern foreclosure property. While the rules strike a balance between the general requirements that a REMIC be passive in its activities with the need for the REMIC to take an active (or owner's) role in the management, operation and disposition of that property, nowhere is this tension more apparent than in the application of the trade or business and new construction prohibitions.

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