Alerts and Updates

# U.S. TREASURY DEPARTMENT PERMITS MORE MODIFICATIONS FOR SECURITIZED COMMERCIAL MORTGAGES

September 23, 2009

The U.S. Department of the Treasury (the "Treasury Department") is now providing greater flexibility for securitized commercial mortgage loans to be modified *before* a loan default occurs or is reasonably foreseen. Nearly two years ago, the Treasury Department and the IRS asked for input on whether federal regulations should be amended to permit more modifications that would not cause an otherwise "qualified mortgage" to lose its qualification and jeopardize the tax status of the Real Estate Mortgage Investment Conduit ("REMIC") holding pools of commercial mortgages in securitizations. The Treasury Department issued final regulations (effective on or after September 16, 2009) to expand the list of permitted modifications that can be made to commercial mortgages held by REMICs. These new regulations are likely to offer opportunities for commercial mortgage borrowers and servicers to agree on modifications to a commercial mortgage without jeopardizing the federal nontaxable status of the REMIC that holds the securitized mortgage.

## Background

As long as it holds "qualified mortgages," a REMIC is considered a pass-through entity and is not subject to federal tax if it otherwise satisfies requirements established under federal statutes and regulations. With certain limited exceptions, REMIC regulations prohibit the "exchange" of one mortgage held by a REMIC for another mortgage. REMIC regulations have treated a "significant modification" of a mortgage as a deemed exchange of the unmodified mortgage for the modified mortgage. The modified mortgage is then no longer considered a "qualified" mortgage and thereby risks the REMIC's losing its nontaxable status. Mortgage servicers are bound by pooling and servicing agreements with regard to the actions they are permitted to take when a commercial mortgage in the portfolio encounters trouble. Many of the restrictions imposed on a mortgage servicer result from the limits of REMIC regulations. For example, changes in mortgage loan collateral or in mortgage guarantees, credit enhancements and changes in the recourse nature of a mortgage loan obligation—and certain lien releases—have been grounds for the potential disqualification of an otherwise qualified mortgage. Until a mortgage loan goes into default, mortgage servicers have been limited by REMIC regulations in the actions they can take with a borrower to modify a mortgage to avoid a future default.

## The New Regulations

The new REMIC regulations permit certain changes in mortgages before the occurrence of an actual default or a reasonably foreseeable default, as long as the loan obligation continues to be "principally secured by an interest in real property." Before these new regulations, unless a default occurred or was reasonably foreseen, only the following were permitted: mortgage defeasance (subject to certain time limitations); waivers of due-on-sale or due-on-encumbrance clauses; and conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage.

The types of additional modifications that are now permitted if the loan obligation is "principally secured by an interest in real property" include: (i) changing a loan from nonrecourse (or substantially nonrecourse) to recourse (or substantially recourse); and (ii) releasing, substituting, adding or otherwise altering (a) a substantial amount of collateral for, (b)a guarantee on, or (c) another form of credit enhancement for a recourse or nonrecourse obligation.

REMIC regulations treat the "principally secured by an interest in real property" requirement as met when the fair market value of the real property securing a loan equals at least 80 percent of the amount of the loan when the loan was originated or contributed to the REMIC. When a mortgage is modified, the regulations require a retesting of the 80-percent requirement. The Treasury Department's expanded list of permitted modifications retains the retesting requirement, but with an alternative method for satisfying that test. A mortgage that is modified by a servicer in any one of the ways permitted will meet the test of being "principally secured by an interest in 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 securing the loan before the modification. This test of premodification and postmodification fair market values may not require a new appraisal. Under the new regulations, this test can be satisfied if the mortgage servicer reasonably believes that the modified mortgage satisfies the 80-percent test at the time of the modification, provided that the servicer has based that reasonable belief on a commercially reasonable valuation method. The new regulations list as acceptable methods: a current appraisal, the updating of an original appraisal or "some other commercially reasonable valuation method"—but the servicer must not know or have reason to know that the value after the modification is less than it was before the modification.

## Conclusion

While borrowers and mortgage loan servicers considering loan modifications before a loan default will still be faced with the limitations imposed on servicers by the specific terms of the pooling and servicing agreement applicable to a particular mortgage, the Treasury Department has—through its new regulations—introduced the possibility of additional flexibility by providing a wider array of mortgage loan modifications that will not jeopardize the nontaxable status of REMICs.

## For Further Information

If you have any questions about this Alert or would like more information, please contact any of the attorneys in the Real Estate Practice Group or the attorney in the firm with whom you are regularly in contact.

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