

REAL ESTATE SECURITIES GROUP **Alert**

www.hf-law.com

David F. Belkowitz
Robert G. Boyle, Jr.
Paul H. Davenport
S. Edward Flanagan
L. Charles Long, Jr.
John F. McManus
Carrie Hallberg O'Malley
William S. Tate
Michael H. Terry

**HIRSCHLER
FLEISCHER**
ATTORNEYS AT LAW

The Edgeworth Building
2100 E. Cary Street
Richmond, Virginia 23223-7078
Phone: 804-771-9500
Fax: 804-644-0957

Mill Race North
725 Jackson Street, Suite 200
Fredericksburg, VA 22401-5720
Phone: 540-604-2100
Fax: 540-604-2101

*This publication is intended for
general information purposes only
and does not constitute legal advice.*

*The reader should consult legal
counsel to determine how laws apply
to specific facts and situations.*

Modifying Securitized Real Estate Loans — New Guidance Provides Flexibility

Over the past decade, many commercial real estate owners financed the purchase of commercial real estate with loans that were securitized by the original lenders as commercial mortgage backed securities (CMBS). Although these loans offered advantages such as lower interest rates, limited recourse and limited guarantees, the tax regulations governing the associated conduits severely limit the ability to modify the terms of such mortgages. In general, the tax regulations prohibit loan modifications unless the modification is due to a default or a reasonably foreseeable default. The tax regulations can impose still penalties - including the possible loss of favorable tax status - on the conduits (but not the borrowers) if the regulations are violated. Because there was little guidance from the IRS concerning what constituted a "reasonably foreseeable default," loan servicers have been reluctant to discuss loan modifications until an actual default occurs.

With the collapse of the CMBS market and the lack of other financing options, borrowers attempting to negotiate with loan servicers prior to the maturity date of their loan have been ignored by the servicers or told that nothing can be done until loan maturity - when the loan defaults. The servicers generally blame their unwillingness to negotiate on the tax regulations. Given that approximately \$150 billion of CMBS loans are scheduled to mature between now and 2012, numerous industry participants asked the IRS to ease the regulations.

The IRS responded to this situation by issuing guidance on September 15, 2009 concerning modifications to CMBS loans.¹ In general, the guidance allows servicers to modify loan terms if the servicer "reasonably believes that there is a significant risk of default of the loan at maturity or at an earlier date." A servicer must document this belief by written facts provided by the borrower. In such a case, the servicer may modify the loan if the servicer reasonably believes that the modified loan will substantially reduce the risk of default.

In determining the risk of default, the guidance states that "one relevant factor is how far in the future the possible default may be." However, there is no maximum period and the guidance states that "a holder 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.” The guidance also states that servicers may reasonably believe that there is a significant risk of default even if the loan is currently performing. Examples of modifications mentioned in the guidance include interest rate changes, principal forgiveness, extensions of maturity and alterations in the timing of changes to an interest rate or to a principal amortization schedule.

The guidance contains an example of a loan that is not in default and is not scheduled to mature for another 12 months. The borrower provides a written representation that it will be unable to repay or refinance the loan at maturity due to factors in the credit markets. Because the servicer reasonably believes that there is a significant risk of default and that the proposed modification would substantially reduce that risk, the servicer and borrower agree to modify the loan by extending the maturity date and increasing the interest rate. According to the IRS, this example is within the scope of its guidance and the modifications will not disqualify the mortgage.

The guidance from the IRS is welcome but it is unclear how loan servicers will respond. Given potential conflicts between the senior bondholders (who might prefer foreclosure) and the junior bondholders (who would rather work with borrowers to avoid foreclosure), loan servicers must balance potentially competing interests in determining whether to modify loans. Moreover, if the volume of modification requests increases substantially, loan servicers may not have sufficient resources to even begin discussions.

Nevertheless, borrowers should consider contacting their servicer up to one year prior to loan maturity to begin loan extension negotiations. Depending upon the terms of the securitization documents and the ability of the loan servicer to focus on the request in a timely manner, servicers should be at least willing to discuss modifications prior to maturity. Similarly, for loans that are converting from interest only to full amortization or for loans that are in danger of defaulting for other reasons, servicers should be willing to engage in modification discussions. While the guidance may not make the servicers any more likely to agree to any proposed modifications, it will at least remove a serious impediment to beginning the negotiations with the servicers.



For additional information, please contact G. Wythe Michael (wmichael@hf-law.com, 804-771-9518) or S. Edward Flanagan (eflanagan@hf-law.com, 804-771-9592).

