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## **The Impact Of Updated REMIC Regulations**

Law360, New York (September 29, 2009) -- On Sept. 15, 2009, the Treasury promulgated final regulations updating the rules related to modifications of loans held in real estate mortgage investment conduits (or "REMICs").

The changes in the REMIC regulations, which apply to all loan modifications on or after Sept. 16, 2009, may have a material impact on servicers of securitized loans because they change the former rules governing modification of such loans.

Those rules provided that a "significant modification" of such a loan could cause the loan to cease to be a "qualified mortgage," which could disqualify the REMIC that holds the loan or subject the REMIC to tax (sometimes referred to as an "adverse REMIC event").

Under the final regulations adopted by the Treasury, even if a modification to a loan is deemed to be "significant" under general tax provisions, the loan will continue to be a "qualified mortgage" so long as the loan remains "principally secured by an interest in real property."

Servicers of securitized loans have long complained that the prior rules prevented them from entertaining reasonable requests from borrowers for loan and collateral alterations and that the rules have not kept up with the practical issues associated with servicing commercial real estate loans.

The final regulations are intended to address these complaints by expanding the class of permitted modifications of securitized loans, but do so at a cost.

### **The Prior Regulations**

The prior regulations contained the following four exceptions to the general rule prohibiting significant modifications of loans held in REMICs:

- 1) changes to a loan's terms that are occasioned by default or a reasonably foreseeable default;
- 2) assumptions of loans;
- 3) waivers of due-on-sale or due-on-encumbrance clauses; and
- 4) conversions of interest rates pursuant to the terms of a convertible mortgage.

## **The New Regulations**

Under the new regulations, the following exceptions have been added:

- Modifications that release, substitute, add or alter a substantial amount of collateral for, a guarantee on, or other credit enhancement for, the loan; and
- Modifications that change the recourse or nonrecourse nature of the loan.

The new exceptions come with an important qualification, however. These modifications are permitted only if the modified loan continues to be "principally secured by" an "interest in real property" following the modification.

For purposes of determining whether a modified loan is "principally secured by" an "interest in real property" the regulations provide the following two tests:

- First, the fair market value of the real property securing the modified obligation must be at least 80 percent of the loan's issue price as of the date of the modification;
- or second, the fair market value of the interest in real property that secures the modified obligation immediately after the modification must equal or exceed the fair market value of the interest in real property that secured by obligation immediately before the modification.

"Issue price," as it is used in this context, may create interpretive issues, but we believe that in most cases it will refer to the outstanding loan balance at the time of the modification.

The fair market value of the interest in real property securing the loan can be based on the servicer's reasonable belief that the modified obligation satisfies either test but must be based on a current appraisal of the property, an update to the origination appraisal that takes into account the passage of time and changes to the collateral property, the sales price of an interest in real property or a catch-all of "some other commercially reasonable

valuation method.”

In addition, a “reasonable belief” does not exist if the servicer has reason to know that the loan is, in fact, not “principally secured by” an “interest in real property.”

The new regulations also make a clarifying update to the so-called lien release rule.

Under the prior terms of Treas. Reg. 1.860G-2(a)(8), if a REMIC released its lien on any real property securing a loan, the loan ceased to be a “qualified mortgage” unless the release was pursuant to a defeasance (or, in the view of most practitioners, the release was one the lender was required to make by the specific terms of the loan documents).

Under the newly adopted regulations, a release of a lien on real property collateral will not cause a loan to be other than a “qualified mortgage” if the release:

- does not result in a significant modification of the related loan or falls under an exception to “significant modifications” found in the regulations (related to default or reasonably foreseeable default, loan assumptions, waivers of due on sale and due on encumbrance provisions, changes to collateral, and changes to the recourse nature of the related loan);

AND

- the loan continues to be “principally secured by” an “interest in real property” under the test described above.

Under the literal language of the new regulations, therefore, every release of a lien on real property collateral (other than in connection with a defeasance) requires that fair market value of the remaining real property collateral be tested and that the valuation component of the “principally secured by” requirement must still be met after the release, even where the release is pursuant to a unilateral right granted to the borrower under the loan documents.

If this was the intent of the drafters of the regulations, servicers will be put in a difficult position where a borrower has a legal right to require that the noteholder release a lien when the release will cause a loan not to be “principally secured by” the remaining real estate collateral.

Similarly, there is no explicit exception for defaults, so a special servicer could arguably be prevented from releasing collateral for a defaulted loan in exchange for a partial paydown of the loan, even if the loan did not meet the “principally secured by” requirement before the release.

## **Caution**

While the regulations may make possible transactions that are not permissible under the prior rules, they speak only to the REMIC issues associated with these transactions.

Servicers must continue to abide by the prohibitions and processes contained in the REMIC's applicable Pooling and Servicing Agreement (or "PSA") (e.g., special servicer, rating agency and controlling class approval; PSA provisions prohibiting substitutions or releases of material portions of loan collateral; etc.), as these provisions are unaffected by the final regulations.

A number of PSAs prohibit a servicer from modifying a loan in any manner that would be deemed "significant" under the provisions of Code Section 1001. This provision was designed to make certain that the servicer did not jeopardize the REMIC's tax status.

Under the new regulations, it is now possible to make certain modifications to a loan in a manner that would be "significant" without affecting the REMIC's tax status.

The issue for servicers will be whether the servicer can, under the terms of the PSA, agree to a modification that results in a "significant modification" of the related loan in violation of the express wording of the PSA but in a manner that does not in any way impact the REMIC's tax status.

A careful review of the applicable PSA provisions for all servicers considering a modification of a loan under the new rules is strongly recommended.

We also anticipate that there will be interpretive questions raised in connection with the components of these new tests. For example, establishing which portion of the value of the collateral is attributable to "real property" may sometimes be problematic where other forms of collateral are also pledged (e.g., cash reserves, licenses, etc.).

## **What Do the New Regulations Mean for You?**

### *Master and Primary Servicers*

For servicers dealing with performing loan requests, the biggest impact of the regulations relates to collateral changes. Under the prior rules, modifications that affect a "substantial amount" of the collateral (often referred to as the "10 percent test") for a securitized nonrecourse loan could result in a significant modification of that loan.

Under the new regulations, such a modification would not cause an adverse REMIC event so

long as the loan continues to be “principally secured by” an interest in real property following the modification.

Servicers have always had to determine the fair market value of collateral for purposes of the “substantial amount” test, but the new regulations raises this burden to a higher level.

In many cases, the fair market value of the property will clearly be enough to justify a conclusion that it is at least 80 percent of the loan’s issue price; in others, that conclusion will not be as clear and the servicer will need to decide how formal a valuation it will need to require.

Also, because the new regulations have no de minimis exception, servicers will have to make this determination even in response to a request for a release of a small out parcel.

### *Special Servicers*

As much as it was hoped that the regulations would provide much more flexibility in the servicing of performing loans held in REMICs, the impact of the regulations on special servicers dealing with defaulted loans and REO is minimal and, in some situations, adverse.

Current REMIC rules related to the grace period for qualified foreclosure property, the prohibition on impermissible new construction for REO and the impact of income from REO that is other than “rents from real property” continue unchanged.

Among the potentially adverse effects of the new regulations is their application in the situation described above with respect to a defaulted loan, where the special servicer wishes to release a portion of the real estate collateral in exchange for a partial paydown of the loan.

If the value of the remaining real property collateral after the release does not equal at least 80 percent of the issue price of the loan after the paydown, the special servicer may be prevented from permitting the release of the collateral, even if the loan did not meet the 80 percent test before the release.

Under the literal terms of the new regulations, it may be possible to avoid this result by writing down the principal amount of the remaining loan in order to reduce its issue price, but this could be viewed by the Treasury as an attempt to avoid the intent of the regulations and special servicers will therefore have to carefully consider such a transaction before undertaking it.

Perhaps the only other impact of the new regulations on special servicers would arise in the uncommon situation of a proposed modification of a defaulted loan that does not fall under the existing exception for modifications that are "occasioned by" the loan's default or a reasonably foreseeable default.

In rare cases, special servicers had difficulty in establishing that, although the loan was in default, the specific proposed modification was actually "occasioned by" that default.

In these odd instances, so long as the modification falls under one of the new exceptions contained in the regulations, no adverse REMIC event would result even if the modification were not considered to have been "occasioned by" the loan's default.

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