
REMIC Reform Proposals Intended to Ease Effects of Stalled Credit Markets

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As maturity dates for billions of dollars in commercial mortgage loans approach and borrowers worry that refinancing will be difficult, if not impossible, Congress and the IRS reportedly are considering modifications to the rules governing real estate mortgage investment conduits (REMICs) used to structure commercial mortgage-backed securities (CMBS). The proposed reforms would facilitate, among other things, the restructuring of commercial mortgage loans before they are transferred to “special servicing” due to a default or a reasonably foreseeable default.

REMICs were first authorized as pass-through entities entitled to hold static pools of mortgage loans as part of the Tax Reform Act of 1986. This favorable tax treatment came with restrictions. Substantially all of a REMIC's holdings are required to be qualified mortgages or certain other related assets. In addition, a REMIC generally has three months after the “startup day” (i.e., the date interests in the REMIC are distributed) to acquire its initial assets, and two years after the startup day to substitute new loans for non-performing loans. Other substitutions are ordinarily prohibited transactions that subject the REMIC to a 100% penalty tax on gain from the exchange. Further, since such substituted loans are not ordinarily qualified mortgages, the REMIC possibly would no longer be treated as a pass-through entity, thus potentially becoming subject to a second layer of tax.

The issue for CMBS borrowers, servicers and investors is that any “significant modification” of a loan held by a REMIC is treated as a substitution, subject to certain exceptions described below. A loan is generally treated as significantly modified if the economic terms change, such as a change in yield, in timing of payments, in the obligor or in the nature (including recourse nature) of the instrument. The regulations provide exceptions in the REMIC context for changes to loan terms in connection with a default or a reasonably foreseeable default, loan assumptions, waivers of due-on-sale or encumbrance clauses and interest rate conversions pursuant to the terms of a convertible-rate mortgage. The narrow scope of these exceptions poses a particular concern with respect to CMBS when borrowers approach servicers to address issues that may occur in the future, because an extension of the maturity date, restructuring of interest payments, or other helpful concessions likely will expose the REMIC to serious tax risks. Faced

with the inability to negotiate loan modifications due to REMIC restrictions and a constrained real estate debt market, CMBS borrowers with sound properties that typically could be refinanced may be forced into default.

Advocates for borrowers and some servicers have been looking to change the rules, and the IRS has taken some steps to respond. In November 2007, the IRS issued proposed regulations that would enable servicers to make certain modifications (including releases and substitutions of collateral in exchange for guarantees or other forms of credit enhancement, and changes to exculpation provisions) to performing loans held by REMICs without such modifications being treated as prohibited transactions or affecting treatment of the REMICs as pass-through entities. Due to the onset of the credit crisis, the IRS also issued guidance concerning REMICs for residential mortgage-backed securities (RMBS). One revenue procedure provides that certain significant modifications making a loan less favorable to the holder will not be treated as prohibited transactions or threaten a REMIC's pass-through status in instances where there is a significant risk of foreclosure that is mitigated by the modifications (provided certain requirements with respect to the underlying property and assets of the REMIC are met). Certain members of the CMBS industry, such as the Real Estate Roundtable, have lobbied for changes to provide similar relief with respect to performing CMBS loans.

Another potential rule change, supported by the American Special Servicers Association, is intended to give servicers the flexibility to dispose of troubled real estate owned (REO) after foreclosure or a deed in lieu of foreclosure, through seller financing, on the theory that a replacement note is similar to the assumption of a defaulted loan. The proposal recommends that it should be acceptable for the terms of the seller financing to be different than the terms of the original loan. (This proposal could have the additional benefit of assisting buyers to finance distressed acquisitions on attractive terms.) Additional proposals may come out of the Senate Banking Committee, where Sens. Chris Dodd and Jack Reed have taken a special interest in REMIC reform.

All eyes are on Washington to develop the appropriate policy response.

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