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Cassin & Cassin LLP

LOOKING BACK – LOOKING AHEAD

The month of January takes its name from Janus. In Roman mythology, Janus is the god of beginnings and endings; most sculptors depict Janus with two heads, facing in opposite directions. So, as we look ahead at 2010, we also look back at 2009 (and not only to be sure that 2009 is really over!).

How will 2009 shape 2010? What decisions of 2009 will have the greatest impact on the commercial real estate sector in 2010? What issues from the past will shape business in the new year? We offer our thoughts on a few of those topics for you, along with our best wishes to you, your family, your colleagues and your organization for a happy, healthy and prosperous 2010.

Federal Estate Taxation: Continuing Uncertainty

January 1 is a common date for changes in tax laws to take effect. Among the notable changes that took effect on January 1, 2010 is the repeal of the Federal estate tax, while the "step-up" in tax basis on the death of the transferor would only apply to the first $1.3 million in assets [1]. This change has been pending for many years, as it dates back to the Economic Growth and Tax Relief Reconciliation Act of 2001. That same legislation also mandated that, as of January 1, 2011, the Federal estate tax would be reinstated (with an exemption of $1 million) at a maximum rate of 55%.

Estate taxation has wide-reaching implications for the families of those possibly subject to it. Given that a significant amount of commercial real estate is owned by individuals and families, any change in estate taxation can also have a pronounced impact on real estate transactional activity. If the status quo remains in effect throughout 2010, the limitation on the "step-up" in tax basis could have a chilling effect on transactions, as heirs inherit properties that have a low tax basis (compounded, perhaps, by the growth of 1031 transactions during the recent boom years), even compared to their current low values.

On December 3, 2009, legislation was passed by the House of Representatives (H.R. 4154) that would set the estate tax at 45% with an exemption of $3.5 million per person, effective as of January 1, 2010. The Senate did not act on the measure before year-end. The election of Scott Brown (R-Massachusetts) to fill the seat formerly held by the late Senator Ted Kennedy resulted in the Republican Party gaining a 41-seat minority in the Senate, which would (if no Republican Senator breaks ranks) prevent the Democratic Senate majority from adopting a bill that would be a "tax increase" in the face of a filibuster.

Cassin & Cassin estate planning attorneys continue to monitor developments in this area carefully, and will be providing information to our clients in this area as changes occur. If you want to receive their updates, please ask your Cassin & Cassin relationship attorney, or contact Joseph Cassin or Mari Galvin.

[1] The Federal gift tax does, however, remain in effect (albeit at a lower rate) for 2010

Deferral of COD Income: An Untapped Benefit?

The "American Recovery and Reinvestment Tax Act of 2009" (the formal name for the February, 2009, economic stimulus legislation) added a new Section 108(i) to the Internal Revenue Code. Section 108(i) provides for circumstances under which a taxpayer may elect to defer the "cancellation of debt" income (or "COD income") that would otherwise be caused by debt forgiveness (such as a discounted payoff of a mortgage loan); if a taxpayer met the conditions set forth, and elected the deferral (deferral being an option, not a requirement), the deferred COD income would be recognized over a five (5)-year period beginning in 2014.

We note that, given the historic timing of real estate cycles, the choice of the 2014-2018 period as the timing in which taxpayers would begin to realize the deferred COD income could overlap with some or all of the next strong upward period in commercial property markets. New projects that would come online during that period would generate new sources of depreciation to offset the deferred COD income, further minimizing the tax expenditures of real estate investors.

Discounted payoffs and other triggers of COD income were lower in 2009 than many had expected. Section 108(i) will expire at December 31, 2010 (unless extended, of course). The second half of 2010 may see taxpayers looking to take advantage of this deferral – if the lenders are willing to cooperate.

Regulation: Which Way Will Government Go?

Government acts through both legislation and regulation. In theory, the regulatory process is meant to do nothing more than implement the policy decisions embodied in legislation; reality is often quite different. With the growing importance of government as a market shaper, what happens when the legislation and the regulation move the market in different directions?

As discussed above, Section 108(i) of the tax code could have been used to facilitate widespread acceptance of discounted payoffs and deeds-in-lieu of foreclosure by banks, by minimizing the tax impact on some borrowers. Taken in concert with the original plan of using "TARP" (the Troubled Asset Recovery Program) funds to buy distressed assets, many saw a clear legislative intent to clear the so-called "toxic assets" off the books of financial institutions as a necessary prelude to further lending.

Two regulatory announcements in the latter part of 2009, though, signaled a move in the opposite direction – down a path that quickly became known as "amend and extend" (or, less charitably, as "amend and pretend"). First, in September, the IRS issued new regulations that allowed unprecedented flexibility for CMBS vehicles to amend the underlying loans. (For further details on this topic, see our October, 2009, Client Alert, available on our website www.CassinLLP.com or from your Cassin & Cassin relationship attorney.) Second, in late October, the "Policy Statement on Prudent Commercial Real Estate Loan Workouts"[2] (the "Policy Statement") was released by the FDIC, Federal Reserve Board and other agencies, addressing how banks should handle troubled loans secured by commercial real estate.

Under the Policy Statement, the bank regulatory agencies gave what is widely understood as clear guidance that regulated financial institutions are encouraged to work out troubled commercial real estate loans, rather than aggressively enforce remedies such as foreclosure or take title to the underlying collateral via a deed-in-lieu of foreclosure. As one example, the Policy Statement noted that "if the institution intends to work with the borrower to get a project to stabilized occupancy, then the institution can consider the "as stabilized" market value in its collateral assessment for credit risk grading…[c]onversely, if the institution intends to foreclose, then the institution should use the fair value (less costs to sell) of the property in its current "as is" condition in its collateral assessment."[3] This created a clear incentive to avoid immediate write-downs that would impact the institution's balance sheet, in favor of any justifiable workout strategy.

The market quickly perceived a common impact from the September, 2009, tax change in the CMBS world, and the October, 2009, regulatory change in the banking world: commercial real estate lenders were encouraged to modify loan terms, in the hopes of a future recovery in values, rather than taking an immediate loss by either a foreclosure, a loan sale, or a discounted payoff. This has had a dampening effect on the broader market, as the lack of activity causes market participants to struggle to determine "real" values, keeping available new capital on the sidelines.

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[2] Available online at http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf.

[3] Policy Statement, above, at page 6.

The markets and the regulators alike professed to be – in the immortal words from "Casablanca" – "shocked, shocked" when, in late 2008, they learned the size of off-balance sheet liabilities of many financial institutions. Under the rules in effect at the peak of the recent bubble, under certain circumstances a company could transfer only a portion of a financial asset (such as a loan), retain control over the asset, and still account for it as a sale.

In June, the Financial Accounting Standards Board (FASB) released two publications – FAS 166 and FAS 167 – intended to change FAS 140, the existing guidance as to how accountants treat two areas: first, securitizations and other transfers of financial assets; and second, certain special-purpose entities called "variable-interest entities", which are defined by the FASB as a business structure that allows an investor to hold a controlling interest in the entity, without that interest translating into possessing enough voting privileges to result in a majority.

Moreover, FAS 166/167 do not apply only to securitization transactions. In the commercial real estate sector, the market for new securitization of commercial mortgages is *de minimis* relative to the overall commercial real estate finance market. Participation sales, however, remain a significant vehicle for structuring new deals and for managing balance sheet exposure to existing credits. Under the amended FAS 140, only *pari passu* participation sales can qualify to be derecognized by the seller, and then only upon satisfaction of the various requirements more fully spelled out in FAS 166. We do note, though, that FAS 166 specifically allows derecognition of transferred financial assets even when the transferring institution has made "standard representations and warranties" in connection with the transfer.[4]

There has been extensive analysis and discussion as to the broad-reaching impact of FAS 166/167, and as to the fears of market participants that it was yet another obstacle to overcome in rebuilding the commercial real estate capital markets. We do not intend to revisit these issues here, but would be glad to discuss them with you separately if that would be helpful. We do note, though, that this is not a closed issue; the March 31, 2010 expiration of the temporary "safe harbor" for securitization transactions that had qualified for "true sale" treatment under the old FAS 140 is approaching quickly. We await the publication of proposed regulations, to see what signals the regulators send.

The Threat of Litigation

The words "lender liability" encompass a wide range of causes of action. Recent months have seen property owners – and their lawyers – reach new highs (or, viewed from another perspective, new lows) of creativity in crafting allegations that lenders are liable for the losses and damages of owners. In one notable example, an affiliate of a well-known New York developer sued a major insurance company, asking that a $65 million mortgage be reduced to 80% of the now-current fair market value of the underlying property (a Long Island shopping center)[5]; the developer, who has been in the real estate business for over 35 years (and who was quoted as saying "I know the value of retail space" in a 1984 New York Times article about his business), alleges that he only wanted to borrow 80% of the value of the property, and that the lender was responsible for the $28 million increase in the property's debt. Elsewhere, after the husband and wife team promoting a luxurious ski resort defaulted on a $375 million financing, their son was among the plaintiffs seeking class-action status against the lender, alleging that the original financing (that itself was the subject of infighting between his parents in their subsequent divorce action) was nothing more than a conspiracy to acquire valuable property at a discount.[6]

Over time, most lenders have developed internal standards that – if followed – should provide adequate protection against any borrower (or would-be borrower) being able to prevail on a claim that the lender somehow caused harm to the borrower. With adequate internal care, few claims result in verdicts in favor of borrowers. Nonetheless, these threats add time, cost and complexity to the resolution of troubled loans.

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[4] *See*, FAS 166 ¶ 8B(c). "Standard" representations and warranties are those that "assert the financial asset being transferred is what it is purported to be at the transfer date. Examples include representations and warranties about (a) the characteristics, nature, and quality of the underlying financial asset, including characteristics of the underlying borrower and the type and nature of the collateral securing the underlying financial asset, (b) the quality, accuracy, and delivery of documentation relating to the transfer and the underlying financial asset, and (c) the accuracy of the transferor's representations in relation to the underlying financial asset."
[5] *See*, Mass OP LLC and Mass One LLC vs. Principal Life Insurance Company, *et al*., filed in New York State Supreme Court, Nassau County, in April, 2009.
[6] *See*, "Credit Suisse Faces a $24 Billion Lawsuit", Wall Street Journal, January 5, 2010.

For our clients in the real estate lending sector, we would be glad to meet with you to review your internal protocols for handling loans that are in default, or in risk of default – or for which the borrower has requested a modification. Please be in touch with your Cassin & Cassin relationship attorney to schedule a meeting.

If you have any questions regarding the foregoing, or other issues, please contact any of the following:

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