LOWENSTEIN SANDLER NEWSLETTER
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NATIONAL NEWS AND DEVELOPMENTS

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Loan Default Rates Continue to Climb

The default rate for non-CMBS commercial mortgages is now the highest since 1992 and is likely to surpass the previous record, according to an analysis of bank and FDIC data by Real Capital Analytics (RCA). At the end of the first quarter of 2010, the default rate stood at 4.17%, or $45.5 billion, up 192 basis points year-over-year and second only to the 4.55% record set in 1992. By year's end, it is projected to surpass the '92 record and peak at 5.4% in 2011, according to RCA.

The news is not good in the CMBS sector either. Though the delinquency rate for commercial real estate in CMBS showed slight signs of moderating in June, with a monthly increase of only 17 basis points to 8.59%, (the best reading since July 2009 and the lowest month-to-month increase in 2010), the forecast for legacy CMBS continues to grow more dismal. Trepp, an independent provider of CMBS and commercial mortgage information, said recently that the delinquency rate for legacy CMBS reached an all-time high in May. May's highest-ever delinquency rate of 8.42% represented a jump of 40 basis points from April, which similarly saw a 41-basis point increase over March, according to Trepp. The CMBS information provider says that aside from February, a month-to-month increase averaging 40 basis points has been the norm since fall of 2009. However, the CMBS market appears to be on a slow mend with June's lower than average increase in loan defaults, an overall spike in issuance compared to the same period a year ago and a glimmer of the first multi-borrower conduit deal since 2007. With investors feeling slightly more confident about the state of the U.S. economy in general and commercial real estate prices in particular, some market analysts who are more optimistic about the strength of the recovery estimate that new issuance could reach as much as $20-25 billion in 2010.

Loan Work-Outs & Modifications: The Importance of the Pre-Negotiation Agreement

The growing mountain of commercial mortgage defaults has resulted in a corresponding increase in loan work-out and foreclosure activity nationwide. Since the capital markets have shown signs of a slow return to a new world of "normalcy" and foreclosure is often a worst-case scenario for lenders, the loan work-out process is frequently the preferable solution for both borrowers and lenders in a defaulted loan scenario. However, before borrowers and lenders begin discussions of any kind in a work-out or loan modification proposal, it is critical for both parties to sign a Pre-Negotiation Agreement (PNA). A well-drafted PNA will confirm: (i) the rights and obligations of both lender and borrower as they relate to any proposed loan modification and/or work-out; (ii) the guidelines governing all discussions and proposals relating to such modification and/or work-out; (iii) that, although the parties agree to "talk" about working out and/or modifying the loan, there will be no change to the existing loan terms until they both agree to and sign formal loan work-out/modification documentation; (iv) that evidence of conduct and communications during the negotiations are inadmissible in any future litigation; and (v) that neither party waives any of its rights and remedies against the other in agreeing to enter into such work-out/modification discussions. Once executed, a PNA will help to facilitate open discussions and negotiations

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among interested parties with respect to a proposed loan modification or work-out before any modification of the loan terms is reduced to a written agreement. With a well drafted PNA, the parties will not unknowingly waive or compromise valuable rights contained in the existing loan documents. Typically, lenders will require a PNA in order to prevent any misunderstanding that they have agreed to some deal unofficially. (The concept of the PNA was developed to help do away with lender-liability suits brought by borrowers claiming that the loan officer had "promised" them loan extensions or modifications during meetings and/or phone calls. The lawsuits actually gained some traction and, at the very least, delayed foreclosures.) On the other hand, some lenders try to materially improve their positions by including in the PNA waivers of claims and defenses, full releases and similar concessions, so such agreements should always be carefully reviewed by legal counsel before they are signed. It is important for a borrower and a lender to discuss a PNA as early in the modification or work-out process as possible in order achieve a more efficient result.

Proposed Major Changes to Lease Accounting Standards

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are considering major changes to the financial accounting standards for leases (FAS 13). Under the proposed changes, all operating leases would be reclassified as capital leases. Such a change would have a significant effect on financial statements and could adversely affect debt covenants and performance ratios commonly included in debt agreements.

Under the existing lease accounting standards, lessees must classify their leases as either capital leases or operating leases, but similar transactions can be accounted for very differently, reducing both the transparency and comparability of financial statements. Critics of the current standards argue that the current standards fail to give an accurate view of a company's liabilities. They believe that a lessee assumes a valuable right when it enters into a lease. In turn, the critics feel that the right to use the leased property should be capitalized as an asset and the present value of future lease payments should be accounted for as a liability. However, if a lease is accounted for as an operating lease, these assets and liabilities are not recognized on the lessee's balance sheet. In order to avoid recognizing the obligation to make payments under a lease, many lessees attempt to structure their lease transactions to permit their leases to be classified as operating leases.

If the proposed changes are adopted, the requirement that lessees treat all leases as capital leases will impact all publicly traded companies and all lessees that produce financial statements in accordance with Generally Accepted Accounting Principles (GAAP). It is important to note that, based on current proposals, existing leases will not be "grandfathered in," so the proposed changes will affect both existing leases and new leases.

In addition to having a significant impact on the balance sheet of a lessee, the proposed changes would also impact a lessee's income statement because, unlike operating leases where lease expenses remain constant through the term of the lease, lease expenses under capital leases are higher in earlier years of the lease than in later years. A lessee's earnings before interest, tax, depreciation, and amortization (EBITDA) will also likely increase as a result of the proposed changes since rent expense will be replaced with interest and depreciation expense, both of which are not included in EBITDA.

These changes affecting a lessee's financial statements and other financial measurements may also impact a large number of corporate covenants, including financial covenants typically found in loan agreements. The impact on a lessee's balance sheet, income sheet and EBITDA as a result of the reclassification of operating leases as capital leases may cause companies to be in violation of financial covenants such as debt-to-total assets and cash-coverage ratios.

Although the proposed regulations are not expected to be adopted until 2011, companies should start evaluating their lease structures now to determine the impact to their financial statements and should also review their debt agreements to determine whether such agreements allow for (or should be amended to allow for) the adjustment of any performance measures or financial ratios in order to account for changes caused by the proposed lease accounting changes.

Carried Interest Legislation That Would Tax Carried Interests in Real Estate Partnerships as Ordinary Income Has Been Tabled

Legislation that would convert a significant portion of the carried interest income of real estate investors from capital gain to ordinary income has been blocked in the Senate (at least for now). The legislation passed the House on May 28 as part of the *American Jobs and Closing Tax Loopholes Act of 2010*.

Current law taxes the "carried interest" of a general partner in a real estate partnership as capital gain. A carried interest (also known as a "promote" or a "promoted interest") consists of the portion of the profit from an investment that is allocable to the general partner and is in excess of the amount attributable to the general partner's actual investment. This promote is typically paid when the underlying real property investment is sold at a profit that exceeds the agreed upon returns to the investors and is designed to give the general partner, typically the developer, a stake in the investment's ultimate success. For example, 20% of the net profit from a real estate partnership's investments might be payable to the general partner even if the general partner only contributed 1% of the fund's capital. The 19% piece would be subject generally to the new legislation.

Under the bill that passed the House, 75% of the income from a carried interest as well as 75% of the gain from the sale of a carried interest, would be taxed at ordinary income tax rates as high as 35% (going up to 39.6% in 2011) rather than the 15% (going up to 20% in 2011) long-term capital gains rate that is applicable for investments held for more than one year.

The legislation has been considered in the Senate over recent weeks. The last version of the Senate Bill contains a provision that would have *decreased* the amount of carried interest that is recharacterized as ordinary income from 75% to 50% for any gain attributable to the sale of an asset held for five or more years. This modification would have applied to any real estate that is held by a real estate partnership for the requisite five year period. However, on June 24, Senate Majority Leader Reid stated that he would table the bill after a third attempt failed to limit debate and advance the bill to a final vote. It is unclear when or if the Senate will again consider the bill.

Since a change in the method of taxation of carried interests will have a significant impact on the real estate investor community, we will continue to closely monitor developments in Washington.

Senate Passes Financial Reform Bill

On May 20, 2010, by a vote of 59 to 39, the Senate passed S. 3217 entitled the *Restoring American Financial Stability Act of 2010* (the "Senate Bill"). In response to the continuing global credit crisis, the Obama administration outlined its framework for financial regulatory reform in its release "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation." On December 11, 2009, the House of Representatives approved a comprehensive financial regulatory reform bill, H.R. 4173, entitled the *Wall Street Reform and Consumer Protection Act* (the "House Bill"). Significant differences between the House Bill and the Senate Bill must be reconciled before a conference committee. That conference process is expected to take several weeks, and proponents of the legislation hope to have the compromise bill approved by the House and Senate and delivered to the President shortly following the July 4th holiday.

Certificate Holder's Bid to Intervene in Stuy-Town Foreclosure Shot Down

Judge Alvin Hellerstein of the U.S. District Court for the Southern District of New York has shot down an investor's bid to intervene in a special servicer's foreclosure proceedings over New York's Stuyvesant Town and Peter Cooper Village housing complexes in order to protect its investment of approximately $750 million in securities backing a $3 billion mortgage taken down to finance the acquisition of the lower Manhattan-based assets.

Attorneys for the investor argued that the special servicer is conflicted as a result of its dual role as special servicer for five trusts that hold the loans and as the controlling certificate holder under the securitization documents. In its February motion, the investor alleged that the servicer's actions in pursuing foreclosure on Peter Cooper Village and Stuyvesant Town violate its obligations to act as a prudent commercial mortgage servicer seeking to maximize value for the benefit of all certificate holders, and further alleged

that the foreclosure will subject the properties to large amounts of transfer tax liability and other costs. As a result, the investor's attorneys argued it had a right to intervene in the foreclosure action as a defendant to protect its interest.

In a ruling issued from the bench, the judge disagreed, ultimately determining that certificate holders cannot interfere with a special servicer's exercise of remedies set forth in the applicable securitization documents, stating that there was no proof that the investor could be a defendant and that, "if anything, it is more aligned with the plaintiffs," Reuters reported.

The Court indicated that the investor could file a separate lawsuit against the special servicer, noting that under the Pooling and Servicing Agreement's provision exposing the special servicer to liability for negligence, certificate holders could sue after the fact for damages they suffer as a result of the special servicer's actions.

This case, Bank of America NA et al. v. PCV St. Owner LP et al. (Case number 1:10-cv-01178, in the U.S. District Court for the Southern District of New York), serves as an important warning to special servicers who simultaneously serve in the role of controlling certificate holder that, while they may be able to proceed with foreclosures, in doing so, they should ensure that they are acting in the best interests of all certificate holders and not just themselves.

New EPA Lead-Based Paint Regulations Go Into Effect

EPA's new regulation imposing federal work practice standards for renovation or repair of building areas that may contain lead-based paint went into effect on April 22, 2010. The rule is designed to protect the most sensitive population (children six years old or younger) from potential health impacts from lead poisoning.

EPA's Lead-Based Paint Renovation, Repair and Painting (RRP) Program regulation at 40 CFR Part 745 requires contractors working in pre-1978 residential properties and certain other properties to implement specified workplace action to prevent lead poisoning of occupants. The EPA requires the certification of contractors performing renovation, repair or painting in residential housing with at least one bedroom, other than housing solely occupied by the elderly or disabled, and other properties occupied by the same child six years of age or younger for at least three hours per day, twice a week, including child care, preschool and kindergarten classrooms. "Minor" projects, defined as repairs involving no more than six square feet of interior surfaces or 20 square feet of exterior surfaces, are exempt from the rule. Window replacement however is not considered a "minor" project, regardless of the number of windows or size of the area being renovated.

Contractors performing renovation at subject properties must have an employee undergo training and receive certification from EPA as a "Certified Renovator." The Certified Renovator may train other firm employees and must oversee all renovation and cleaning projects at subject properties. Contractors also must inform the occupants of the property of the rule, provide a lead paint pamphlet to the occupants, and document and maintain work practice records.

The area of the property being renovated must be contained to control the spread of dust and debris to other areas of the structure being renovated. Specifically, plastic sheeting must be extended six feet in all directions from the work area; and the entrance of the work area must be posted with a warning sign. In addition to other mandated cleaning practices, a HEPA (high-efficiency particulate air) vacuum must be used to clean up the work area.

EPA's prior rule allowed a homeowner to opt out and waive compliance with the best practices portion of the EPA rule if there were no children under six or pregnant women residing in the home. However, EPA recently amended its rule to revoke the opt-out election as of July 6, 2010.

Title Insurance - Creditors' Rights Coverage Withdrawn

In case you missed it, the Board of Governors of the American Land Title Association voted to decertify the ALTA Form 21 Endorsement, commonly referred to as the "Creditors' Rights Endorsement," effective as of March 8, 2010. While a Creditors' Rights Endorsement has not been available for some time in states such as New York, New Mexico and Texas, the withdrawal of this endorsement has now affected both New Jersey, Pennsylvania and other states where the Creditors' Rights Endorsement had been available. The ALTA 2006 policy form excludes coverage for losses resulting from a finding that a transaction represented a fraudulent conveyance and for

claims resulting from a transaction being deemed a preferential transfer. The ALTA 21 form insured policy owners against "loss or damage sustained by the insured by reason of the avoidance, in whole or in part, or a court order providing some other remedy, based on the voidability of any estate or interest shown in Schedule A or the Insured Mortgage because of the occurrence on or before Date of Policy of a fraudulent transfer or a preference under federal bankruptcy, state insolvency, or similar creditors' rights laws." The decertification of this endorsement reallocates the risk from title insurers to the insureds and may force lenders to perform additional due diligence to understand the financial creditworthiness of its borrowers.

Please contact any member of Lowenstein Sandler's Real Estate Practice Group with questions regarding the topics discussed in this newsletter.

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