



October 3, 2008

Because of the rapidly changing conditions in the financial markets, we have established this special series of Client Alerts to advise you of the newest economic and legal developments and their wide-ranging business implications.

HOW COMMERCIAL MORTGAGE LOANS ARE AFFECTED BY THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

An Overview of EESA

The Emergency Economic Stabilization Act of 2008 (“EESA”) provides up to \$700 billion to the Secretary of the Treasury to buy mortgages and other assets from financial institutions.¹ Some aspects of the bill apply more broadly to financial institutions, but the core of the legislation is the Troubled Asset Relief Program (known as “TARP”).

The heart of the credit crisis has been the contagion in the credit markets initially caused by subprime loans and other single-family residential loans which were either originated without adequate underwriting (e.g. so-called “liar” loans) or in which the loan balance now substantially exceeds the collateral value due to the precipitous decline in home values over the last year. The initial focus on the purchase of troubled assets by the Treasury under EESA is therefore likely be on the purchase of residential mortgage loans and securities, including residential mortgage-backed securities (RMBS) secured by residential mortgages.

However, there is also a growing crisis involving commercial real estate loans, particularly commercial real estate loans used to finance land, acquisition and development loans to developers of single-family residential projects and financing for residential condominium projects².

The Act addresses the purchase of troubled assets in the form of both residential and commercial mortgages as well as securities backed by those mortgages.

Purchase of “Troubled Assets”

Section 1.01 of the Act authorizes the Secretary of the Treasury to purchase troubled assets from any financial institution (as defined in the Act) in accordance with the Act and the policies and procedures to be developed and published by the Secretary.

What are Troubled Assets under the Act?

“Troubled assets” are defined under EESA as follows:

TRoubLED ASSETS.—The term “troubled assets” means:

¹ This summary is based on the version of the Act passed by the Senate on October 1, 2008. The House of Representatives enacted the Act without changes on Friday, October 3, 2008.

² See, e.g., *After Lehman, Banks Jettison Commercial Property*, The Wall Street Journal (September 17, 2008). See also *Collateralized Damage: Commercial Mortgage Securities Are at a Standstill* (July 23, 2008) at [www.http://knowledge.wharton.upenn.edu](http://knowledge.wharton.upenn.edu)

(A) residential or **commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages**, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and

(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

Commercial Mortgages

TARP expressly includes “commercial mortgages” in addition to residential mortgages as “troubled assets” covered by the Act.

This would include commercial whole-loan mortgages made and held by a single financial institution and whole-loan commercial mortgages acquired from a correspondent or other third party.

The Act does not define “commercial mortgages” but instead leaves it up to the Treasury to issue regulations and guidance to define terms or carry out the purposes of the Act.

“Commercial mortgages” presumably includes mortgages (and other security instruments, such as deeds of trust and deeds to secure debt) secured by real estate (both improved and unimproved) in which the real estate is used for business purposes. The term should be broad enough to cover commercial mortgage loans securing real estate of all types, including land loans, acquisition and development loans, construction loans and term loans.

Loan Participations

What about participations in commercial mortgage loans, a loan structure that is very common among community banks?

Since a participation interest, unlike a syndicated loan interest, only gives the participating financial institution a contractual claim against the lender making the loan and does not make any of the participants lenders to the borrower, the good news is that any purchase of a whole mortgage loan by the Treasury from the lead lender should result in the Treasury assuming the obligations of the lead lender to the participant. Whether the Treasury will purchase any participation interests from a troubled lender without purchasing the entire loan is an open question.

Syndicated Real Estate Loans

With a syndicated real estate loan, each member of the syndication group is a lender to the borrower and each lender’s individual loan is secured by a mortgage granted to a collateral agent representing all of the lenders. A note held by a syndicated lender secured by a mortgage on real estate would therefore appear to qualify as an “instrument...based on or related to such mortgage.” As a practical matter, however, the Treasury may not want to acquire a syndication member’s interest in a syndicated real estate loan unless it can acquire the agent bank’s interest and enough interests of all members of the syndicate so that it controls decisions about the loan and the real estate collateral.

Exclusion of OREO

“Troubled assets” includes only financial assets and not “hard” assets such as Other Real Estate Owned (OREO) held by banks or real estate held by other financial institutions following foreclosure or deed-in-lieu transactions. The Act does contain provisions (in Section 103(9)) directing the Treasury to consider “the utility of purchasing other real estate owned and instruments backed by mortgages on multi-family properties.” However, until further guidance is provided by the Treasury, it should be assumed that OREO and other real estate owned by a financial institution following a foreclosure or deed-in-lieu transaction does not qualify as a “troubled asset”. Financial institutions will need to consider timing issues on foreclosures since acquisition of the real estate following foreclosure would remove the real estate from



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the “troubled asset” category under the present definition unless the Treasury issues guidance or regulations in the future to cover OREO.

Mortgage-Backed Securities

In addition to covering commercial mortgages, the Act also authorizes Treasury to buy “any securities, obligations, or other instruments that are based on or related to such mortgages” which the Secretary determines promotes financial market stability.

CMBS

Commercial mortgage-backed securities (CMBS) will certainly be included as troubled assets under the Act. The CMBS market includes a variety of commercial property types, including office, retail, industrial and healthcare facilities.

CMBS transactions are structured through a vehicle that provides investors purchasing bonds secured by a pool of mortgages with different tranches of bonds that pay different interest rates based on the level of risk and ranging from AAA rated bonds to unrated bonds. Triple A bonds are at the top of the highest tranche of the CMBS structure and are considered the safest and least risky investment in CMBS. However, in the present credit and real estate market, finding buyers for even AAA rated bonds has been much more difficult³. The so-called “B-piece” of CMBS refers to bonds rated BB+ and lower. Finding buyers for the B-piece in CMBS transactions has been even tougher.

CRE CDOs

Another method of securitizing commercial mortgage loans that has developed over the last few years is the commercial real estate collateralized debt obligation (CRE CDO). Both financial institution’s ownership of investment interests in CRE CDO and unsold pieces of these deals should fall easily into the definition of “troubled assets.”

CDOs

In addition to CDOs involving only real estate, CDO pools can be limited to certain non-real estate asset classes or may include a diversity of asset classes including mortgage-backed securities, asset backed securities and corporate debt. Generally, if a default occurs on a loan included in a CDO, the collateral manager can buy the defaulted loan out of the pool.

Purchase of Non-Real Estate Assets or Mixed Assets.

If a CDO does not qualify as a troubled assets in the form of a security “based on or related to” residential or commercial mortgages under Section 1.01 (A), it can still qualify as a troubled asset under Section 1.01(B) which permits the Secretary of the Treasury to determine that the purchase of any other financial instrument (i.e. other than instruments and securities based on or related to residential or commercial mortgages) is “necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.” Although not the subject of this Alert, this provision would permit the Treasury to identify as “troubled assets” subject to purchase non-real estate loans such as student loans or automobile loans.

³ See, e.g., *CMBS Woes Stymie Commercial Property Deals* by Beth Braverman (August 25, 2008) in Financial Week, www.financialweek.com

Definition of Financial Institutions.

TARP authorizes the Treasury purchase “troubled assets” from “financial institutions.” The term “financial institution” includes, but is not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State, territory, or possession of the United States and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government. The definition does not cover hedge funds.

Contact Information

If you have questions regarding the effect of EESA or the TARP provisions on commercial mortgage loans and related securities, or about this client alert, please contact [Gary Chamblee](#), the principal author of the alert, or another member of our [Capital Markets Practice Group](#).

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