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The Ongoing "Credit Crisis" in Commercial Real Estate Lending – An Update

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This is an update of an article I wrote in the Summer 2008 Newsletter for the Real Property Probate and Trust Section of the Washington State Bar Association. The article I wrote was an attempt to describe the dramatic changes in the Commercial Mortgage Backed Securities market that occurred in the early part of 2008 and the impact it had on commercial real estate lending. I also attempted to offer my own perspective about how practitioners could assist clients with the sudden collapse of the commercial real estate lending market. This update will describe some of the significant developments affecting the lending market since the summer of 2008, describe the looming crisis affecting commercial real estate and again offer my thoughts about how practitioners are currently addressing the momentous challenges affecting their clients.

It is almost unimaginable how much has occurred in the real estate and banking markets since the summer of 2008. I thought that the loss of the CMBS market was an alarming change that might affect our practices and real estate clients; a change warranting the discussion contained in my earlier article. However, I had no idea that three months later we would witness the kind of macro-economic convulsions that ripped through the world economy. Lehman Bros., AIG, Freddie Mac, Fannie Mae, TARP, TALF, Bailout, and Double-Digit Unemployment all become part of the daily lexicon used to describe the events of the fall of 2008. The events of that period and the resulting economic carnage have led many economists to characterize the period from 2007-2010 as the worst financial crisis since the Great Depression.

The statistics are sobering. Between June of 2007 and November of 2008, Americans lost on average more than one-quarter of their collective net worth. During one week alone in September of 2008, more than $144 billion was withdrawn from money market accounts. The worldwide panic and ensuing "run on the bank" threatened an imminent collapse of the short-term commercial paper markets and forced the U.S. government to respond with the Emergency Economic Stabilization Act of 2008 (EESA). The authority for the now famous or infamous "TARP" came from the EESA. Approximately $14 trillion of household wealth disappeared after 2007. The stock market lost 45% of its value by November of 2008. There are estimates that commercial real estate market prices dropped 30-50% from recent peaks.

Although there has been some stabilization in other areas of the economy e.g., commercial paper, stock market valuations and unemployment losses, the challenges facing commercial real estate and commercial real estate lending continue. In fact, the Congressional Oversight Panel (established under the EESA) issued this dire warning on February 10, 2010:

> Over the next few years, a wave of commercial real estate loan failures could threaten America's already-weakened financial system. The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation's mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy.

The Panel noted that more than $1.4 trillion in commercial real estate loans will require refinancing within four years. Nearly

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half of those loans are held by borrowers who owe more than the properties are worth. The expected losses could exceed $300 billion and threaten more than 3,000 banks nationwide.

The damage has already begun. We have witnessed tremendous adverse impacts to our local commercial lending base. Stalwart names like Washington Mutual, Frontier Bank, Evergreen Bank, Homestreet Bank, Sterling Savings, American West Bank and others have failed or become otherwise subject to FDIC cease and desist orders. More than 30 banks in Washington State alone are subject to cease and desist orders or other extraordinary regulatory oversight requirements.

I discussed the collapse of the CMBS market in the 2008 article noting that it did not appear to be feasible or even possible for traditional lenders to replace the $200 billion of commercial real estate financing previously provided each year by the CMBS market. However, the economic contagion unleashed in 2007-2008 has clearly spread and wiped out much of the traditional lending community's ability to provide any financing for commercial real estate. It is this realization, together with the recognition of the inexorable connection among commercial real estate, regional and community banks and the overall economy, that caused the Congressional Oversight Panel to issue the dire warnings about the near-term future.

Dramatic Times During the Fall of 2008

In the fall of 2008, the "credit squeeze" or "credit crunch" developed into a worldwide crisis. The initial problems related to a housing bubble collapse in 2006-2007 that hammered residential housing prices and performance rates for home mortgage products and promptly interrupted available credit for new residential mortgages. High default rates occurred for subprime, adjustable rate and other mortgages following the housing bubble burst. The higher default rates quickly caused problems with a wide variety of securities that had been backed by residential mortgages. MBS, or mortgage-backed securities, are the securitization of large pools of residential mortgage obligations as bonds whose cash flow is derived from principal and interest payments on mortgages. MBS were designed as a tool to generate liquidity for lenders who could sell their interests in residential mortgages and increase available capital for residential borrowers. CDO or collateralized debt obligations, are structured investments that hold debt as collateral and issue long-term liabilities as securities in various tranches. Some CDOs are set up to hedge credit risk and reduce capital requirements for lending institutions, and other CDOs are designed to earn higher fees and collect interest on high-yield debts. The sudden drop in value of MBS and CDOs created problems with other exotic debt and insurance products, including Credit Default Swaps (CDS) that were engineered to mitigate risk of residential mortgage loss.

It is not surprising that the significant increase in housing valuations during the 1990s and 2000s was linked to increasing leverage and ease of available debt. For example, U.S. home mortgage debt relative to U.S. gross domestic product increased from 123% in 1981 to 290% in 2008. The price of an average American home increased by 124% between 1997 and 2006. Large sums of institutional and foreign capital were directed to the residential mortgage market creating a "shadow" banking system outside of the normal regulatory restrictions imposed on the traditional banking industry. Innovative financial products such as mortgage-backed securities and CDOs were created to facilitate greater investment in residential mortgages and offered as "safe" alternatives to U.S. Treasury bonds. Backed by rating agency approval, MBS, CDOs and other structured investment vehicles grew dramatically. The growth intensified as more risky investment structures were rolled out i.e., "sub-prime," "adjustable rate" and "no document" mortgage products. For example, the combined assets for the top five major investment houses – Bear Stearns, Lehman, Goldman Sachs, Morgan Stanley and Merrill Lynch – were approximately $4 trillion in 2007, much of it made up by MBS, CDOs and other structured investment vehicles. The total assets of the top 5 regulated banking holding companies for that same period were $6 trillion, and for all regulated banks $10 trillion. Essentially by 2007, the "shadow" banking system rivaled the size of traditional banks, but a huge percentage of foreign and institutional investor assets (including traditional banks) were heavily invested in the shadow banking system and its residential mortgage products. The stage was set for a momentous collapse because of the incestuous link between the shadow banking system and traditional banks and other institutional investors – all relying on the health of the residential mortgage business.

A domino effect began in 2007. As home mortgage default rates increased, mortgage lenders began to fail. Northern Rock and Countrywide Mortgage, two of the largest mortgage lenders in the U.K. and U.S., were no longer capable of financing residential mortgages. Nearly 100 mortgage lenders filed for bankruptcy during 2007-2008. Two hedge funds owned by Bear Stearns that had heavily invested in subprime mortgages collapsed creating fears of a melt-down for Bear Stearns itself.

In March of 2008, the Federal Reserve prevented a Bear Stearns bankruptcy by assuming liabilities and requiring a sale of assets to JP Morgan Chase. In August, the stock prices of Fannie Mae and Freddie Mac dropped precipitously and the government was forced to take over both entities on September 7, 2008. Later in September, the government refused to help Lehman Bros., which was forced to file for bankruptcy protection. Merrill Lynch quickly merged with Bank of America to prevent a bankruptcy filing. On September 16, AIG received $85 billion in emergency aid from the government and the NY Stock Exchange dropped almost 500 points. AIG had been instrumental in issuing CDS (credit default swaps) used to hedge or speculate against mortgage

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rate loss akin to an insurance policy. The CDS products were designed to appease investor concerns about possible MBS and CDO default problems. It quickly became apparent in September of 2008, however, that AIG did not have the financial ability to honor its claim obligations under the credit default swaps.

During the same momentous month of September 2008, billions of dollars were suddenly pulled from money market accounts worldwide as the meltdown continued. Interest rate spreads for short-term loans skyrocketed. The U.S. government was forced to guarantee all money market deposits in an attempt to stave off a complete run on the money market system, which was critical to the short-term commercial paper needs of businesses throughout the globe. Other governments followed suit and took similar emergency action.

On September 18, 2008, Treasury Secretary Henry Paulson met with several members of Congress to propose the $700 billion emergency bailout program famously stating: "If we don't do this, we may not have an economy on Monday." Mr. Paulson's comments brought home the painful realization that the world economy had been unknowingly linked with the health of the residential housing business. The sharp decline affecting residential housing caused enormous disruptions of the global financial markets.

Governmental Action

The financial crisis that reached a climax in the early fall of 2008 led to extraordinary measures by governmental entities. The $700 billion bailout plan (later codified as the EESA) was originally designed on three hurried pages to allow the federal government to purchase toxic assets from banks. The theory was that the proposal would strengthen the balance sheets of the nation's banks and improve investor and depositor confidence in the overall financial system. The government had realized quickly that U.S. banks faced enormous losses as a result of their investments in "toxic" residential mortgages and mortgage-related investments. In fact, the International Money Fund estimated that major European and U.S. banks lost more than $1 trillion by September of 2009 and forecasted that losses will exceed nearly $3 trillion by the end of 2010. The losses suffered by banks and other institutions combined with the collapse of investor funding for mortgage backed securities, commercial paper, etc., effectively froze available liquidity for the overall financial system.

The EESA was reworked by Congress and adopted in October of 2008. It allowed the government to acquire preferred stock interests in the nation's banks and acquire commercial paper in an effort to relieve the constricted credit flow affecting businesses. Central banks around the world also responded by dramatically cutting interest rates and injecting to the global financial system the largest amount of liquidity in history. Other governments stepped in to guarantee investor deposits as fears of bank runs intensified. On December 16, 2008, the Federal Reserve dropped its benchmark rate to nearly zero percent and announced it would deploy its balance sheet to increase monetary supply. Worldwide stock markets nevertheless continued to slide throughout the fall. Unemployment rates increased. U.S. GDP dropped 6.2 percent in the last quarter of 2008.

Beginning in January of 2009, the government faced monumental issues about a possible nationalization of banks to strengthen the anemic financial system. Simultaneously, the government implemented a massive economic stimulus bill to prop up a moribund economy. Throughout late 2008 and 2009, a myriad of other governmental measures were rolled out including TALF (Term Asset Backed Securities Loan Facility – an attempt to restart lending for asset backed securities), PPIP (a Public Private Investment Program designed to combine TARP funds with private investment to assist in the purchase of "toxic" assets from banks), "Bank Stress Test" (a plan to conduct stress tests on the nation's 19

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largest banks to determine capital requirements for these banks), and a Housing Assistance Plan ($275 billion to allow refinancing or modification of home mortgages).

Ironically, as the government rolled out its measures and struggled to determine the best course, several positive trends began to occur in the spring of 2009. Short-term commercial paper markets appeared to stabilize as a result of the easing liquidity offered by governmental intervention. The Bank Stress Test process was implemented and completed and appears to have been successful. Many of the largest banks were able to repay TARP funds with successful common stock offerings. The New York Stock Exchange improved dramatically throughout the summer of 2009. The unemployment rate seems to have stopped a free-fall and settled near the 10% range.

Commercial Real Estate, CMBS and Lending

The resulting fallout from the overall financial crisis described above has certainly impacted commercial real estate, the commercial mortgage backed securities market (CMBS) and real estate lending in general. I described the CMBS collapse in my last article. The trends during 2008-2010 have, unfortunately, not improved.

In the earlier article, I described how the credit crisis had stymied new production of CMBS issuances. For example, in 2007, CMBS issuances were nearly $200 billion. In 2008, the number of issuances was less than 10% of the prior year's figure. The lack of investor confidence that plagued the residential MBS market also occurred in the CMBS market. In fact, between July of 2008 and May of 2009, there were no CMBS issuances at all.

Commercial real estate valuations have fallen 30-50% from peaks reached in 2007. The recession has created a dramatic and pervasive deterioration of real estate fundamentals, including escalating vacancy rates and declining rental prices. Capitalization rates have increased resulting in lower property values. Obviously the decreased cash flows severely impact debt service coverage ratios and the ability of borrowers to make loan payments. Lower property values cause higher LTV ratios. The higher LTV ratios make it difficult for borrowers to refinance loans. In fact, loans for retail properties in 2009 dropped an estimated 62%, loans for office projects dropped an estimated 56% and loans for apartments dropped an estimated 40%. Yet, as the Congressional Oversight Panel notes in its February 2010 report, nearly $1.4 trillion of commercial real estate loans held by the CMBS and portfolio lending institutions (traditional banks and life insurance companies) must be refinanced between the years 2010-2014 because of approaching maturity dates. Approximately 50% of those loans are secured by real estate that is "underwater" where the borrower owes more than the property is worth.

Other disturbing trends are at play. The overall CMBS delinquency rate increased from 2008 to 2009 by more than 326%. I mentioned in 2008 that the extent of the CMBS loan problem was unclear at the time. At that time, the default rate for CMBS loans was less than 1% but it is now clear that the default rate for CMBS loans has increased and will likely continue to increase dramatically. A similar trend has hit portfolio lenders. The Congressional Oversight Panel estimates that bad loan losses could be as high as $300 billion, threatening more than 3000 small and mid-size banks, in addition to losses facing CMBS mortgage pools. Losses faced by the CMBS and portfolio lending markets plus a lack of investor demand for CMBS issuances will severely impact refinancing options for real estate borrowers. The Congressional Oversight Panel concludes essentially that the combination of declining real estate fundamentals, valuation losses, increasing CMBS/ portfolio lender defaults and the corresponding unavailability of credit creates a dangerous threat to commercial real estate and the overall economy.

I highly recommend that anyone reading this update also review two publications that might shed light on the extent of the problems facing the commercial real estate industry and the possible governmental actions that might be taken to confront the risks posed to the greater economy. The first publication is the February 10, 2010, Oversight Report entitled "Commercial Real Estate Losses and the Risk to Financial Stability" issued by the Congressional Oversight Panel. The second is the Federal Reserve Policy Statement on Prudent Commercial Real Estate Loan Workouts issued on October 30, 2009. I believe that the Oversight Report and the Policy Statement recognize the very careful balance facing federal regulators charged with trying to assist banks in addressing problem commercial real estate loans and impending maturity dates. The Panel does not offer any tangible recommendations but urges bank regulators to carefully assess the issue: "The [COP] is clear that government cannot and should not keep every bank afloat. But neither should it turn a blind eye to the dangers of unnecessary bank failures and their impact on communities." The Panel hints that TARP or a TARP equivalent might be needed to prevent the kind of damage that could occur from the commercial real estate crisis. The Panel also suggests that the stress tests conducted on the nation's largest banks should be conducted on the large number of community and regional banks that are heavily exposed to potential commercial real estate losses. The Policy Statement cautions regulated financial institutions against premature acceleration of losses from commercial real estate loans. It states: "...renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance."

My personal opinion is that governmental officials and federal regulators have conceded that there is no easy way out of the current crisis affecting commercial real estate financing. I believe that this recognition is well-founded. In contrast to the last commercial real estate crisis occurring in the late 1980s and early

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1990s, the current crisis is a national phenomenon. The savings and loan crisis involved many banks and thrifts, but most tended to be small, regional institutions where real estate lending was concentrated in specific geographic areas. The federal response to the crisis led to creation of the Resolution Trust Corporation which took over many failed thrifts and quickly re-sold assets in the private market. CMBS developed as a means of facilitating liquidity to acquire assets from the RTC in the early to mid 90s and was a highly efficient source of capital for commercial real estate acquisitions. The RTC was more inclined to accelerate the recognition of losses and remove toxic assets from a federal balance sheet.

Today, there is no similar source of liquidity to finance acquisitions. Private capital is still on the sidelines. Banks are reluctant to recognize losses and the federal regulators seemed disinclined to force banks to recognize losses and move assets. Accordingly, the ability of banks to provide liquidity for acquisitions is severely diminished. The credit contagion seems to have affected every region of the country and severely weakened a large percentage of financial institutions. This reluctance to force banks to recognize losses and purge balance sheets of toxic assets seems to be creating a wedge between banks holding REO assets and the potential buyers who won't accept anything other than bottom-basement prices. In fact, the large private equity funds formed to pounce on opportunistic real estate opportunities are facing historically low levels of activity and commercial Grade A acquisition activity until recently has been quite slow.

The Bar in Action

The recommendations and perspective described below are my own and are based solely on my experiences to date. I offered a number of recommendations in my earlier article – recommendations that I believe continue to be valid in today's challenging environment. I also believe that today is one of the most rewarding times to be in the real estate practice despite the challenges. During the "heady" times over the past few years, the practice became commoditized. Attorneys were asked to churn documents as quickly as possible based on the underlying assumption that real estate financing and real estate transactions were standardized and to be memorialized by boilerplate forms. I think that the industry operated under the belief that any substantive analysis of issues for leases, purchase agreements, loan agreements, etc. had been resolved in the past and that real estate attorneys were mere scriveners. The events of the last couple of years have destroyed those underlying assumptions as real estate attorneys are being asked to think outside of the box to solve problems that have not been faced for a generation. We now must be experienced and thoughtful counselors first and foremost and we have the chance to be at the forefront of an industry that is remaking itself.

1. **Workouts, Workouts, Workouts.** Long-term practitioners will recall times when a real estate practice meant being a workout specialist. Real estate attorneys have not been required to develop a workout practice for years, but many of our real estate clients have already spent the last 18 months and will spend the foreseeable future attempting to work themselves out of problem loans. The deteriorating real estate fundamentals as described in the Congressional Oversight Panel report have hit the Washington state economy quite hard. Our regional and community banking business has been particularly hurt by the sharp decline in commercial real estate valuations. Ironically, borrowers are in a better position to negotiate because of the severity of the recession and the resulting impact on local and regional banks. As I mentioned earlier, banks are, in fact, being encouraged by the Federal Reserve to renew and restructure loans.

A workout practice requires familiarity with basic real estate, lending, bankruptcy, litigation, and tax. Practitioners should brush up on the basics of bankruptcy and the important tax issues associated with cancellation of indebtedness or modification of interest rates to be in a better position to advise clients about a loan workout. Long-term practitioners will recall that successful workouts often involved appropriate use of bankruptcy and litigation threats against lenders that failed to negotiate in good faith. Bankruptcy was a credible threat because of the inordinate delays facing a lender that wanted to foreclose on real estate assets. The laws have changed significantly since the early 90s. Bankruptcy filings for single asset bankruptcies are now subject to very short-plan confirmation periods and offer little in the way of viable protection for a borrower unable to make regular mortgage payments. Moreover, many non-recourse loans are structured with "springing recourse" guaranties for individuals that become effective if a borrowing entity files for bankruptcy. This tactical development has not been tested much to date in the bankruptcy courts, but there is no question that it is having a chilling effect on the number of real estate bankruptcy filings. There is also some debate about the value of bankruptcy to forestall a foreclosure resulting from the borrower's failure to pay a balloon payment because of the lack of available financing. I encourage practitioners to review *In re General Growth Properties, Inc*, Case No. 09-11977 (ALG)(Bankr. S.D.N.Y. April 16, 2009). The case discusses the intricate SPE and bankruptcy remote provisions used by the CMBS market in an attempt to prevent real estate bankruptcy filings. The court concluded that it would not enforce such provisions. Moreover, the court seemed to be sensitive to the need for a bankruptcy filing for a real estate owner confronted with the meltdown in financing options. It is unclear if emerging bankruptcy law will provide real estate owners protection to ride out the current lending crisis and the palpable lack of liquidity in the real estate financing market.

Threats of litigation against lenders are generally no longer viable. RCW 19.36.110 was enacted in the 90s to make it clear that oral agreements to modify loan documents were not enforceable. This legislation was enacted to address borrower claims of lender bad faith and breach of contract for oral agreements to

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extend or modify loan agreements. Borrowers often used these claims to create additional time in the litigation process to seek a negotiated settlement with lenders. In today's world, many lenders are protected against claims of oral extensions or modifications by statute or clarify the issue in "Pre-Negotiation" agreements. These agreements explicitly state that a lender is not bound by any modification discussions and more importantly require a borrower to waive any possible claims before a lender will even meet with a borrower to discuss a loan modification.

2. **It's the Plan, Stan.** Despite changes in the bankruptcy code and lender liability law, borrowers have tools at their disposal. As mentioned earlier, many banks are quite hesitant to recognize losses by initiating foreclosure proceedings. Foreclosure actions and non-accruals for loans cause significant balance sheet problems for banks. A practitioner should consult the FDIC or State Department of Financial Institutions website for a description of troubled banks and the balance sheet issue facing these banks. Practitioners can get up-to-date information about financial institutions by referring to the Call Reports described in cdr.ffiec.gov/public. Access to this information can assist practitioners in evaluating the financial health of banks – information that can be quite useful in formulating a viable workout plan that would allow the bank to defer a large loss. The regulators are recognizing this problem and urging banks to work out problem loans, especially loans that have impending maturity dates. Essentially, the severity of the recession is leveling the playing field between lenders and borrowers.

Borrowers can take advantage of this by approaching banks proactively with an intelligent, well-described plan to remedy the loan problems. The plan should contain current rent and expense information and reasonable pro forma projections, describe any deferred maintenance or capital improvements required for the project, describe tenant improvement estimated requirements, and describe a viable exit strategy e.g., GSE lender take-out for a multi-family project or perhaps a conversion of the current lender's loan to a longer-term debt facility with principal amortization. Again, I suggest that practitioners review some of the recommended "work-out" examples cited by the Federal Reserve in its Policy Statement on Prudent Commercial Real Estate Loan Workouts. These examples can be offered as reasonable ways of structuring loan workouts to protect borrower and lender interests. The Congressional Oversight Panel also commented on this trend of having lenders work themselves out of problem loans rather than merely relying on quick foreclosure and loss recognition. Some view the "extend and pretend" strategy used by many banks to avoid loss recognition as merely postponing the inevitable but the Panel concluded: "For every 'extend and pretend,' there can also be an 'extend and soundly lend.'"

3. **Don't Make it Personal.** Borrowers should strongly consider using third-party consultants or workout specialists to approach local and regional banks about a proposed workout. Often these consultants are former credit officers for banks and have a strong awareness of issues affecting local or regional banks. As a board member of a community bank, I know that many banks take loan defaults personally and the resentment can stymie efforts to initiate productive workout discussions. A third-party independent consultant, however, can greatly reduce lender resentment. Some of the most successful borrower workouts occurring in the area have been led by third-party consultants.

Borrowers should be prepared to think creatively about solving loan problems. Most community and regional bank officers are not experienced with creative deal structuring. Banks that issued acquisition and development loans, for example, might be facing plummeting land values and the realization that the bank will never recover its loan basis in the land by a post-foreclosure sale. The only viable option for the bank and a borrower is to develop their way out of the problem. That is occurring in this market as lenders try to work with home builders on a home-building strategy that hopefully will make the lender and builder whole again. Other examples include defaulted construction loans for condo projects. Many banks don't have the expertise to convert a simple land loan to a construction loan or administer a construction loan. An experienced practitioner can help by suggesting viable construction loan procedures to allow for a development strategy. Other strategies include structuring of shared appreciation mortgage, equity kicker and similar provisions that allow a bank to profit following completion and sale of a development project. Again, given the alternatives facing many banks, creative thinking can greatly assist banks and borrowers in structuring credible workout strategies.

4. **Make Yourself Attractive.** Many borrowers are struggling to find refinancing options. Again, as a board member of a community bank, I can tell you that most banks are completely shying away from commercial non-owner occupied real estate loans. However, creative borrowers can repackage real estate loans as "credit" loans by urging banks to issue personal lines of credit backed by a comprehensive pledge of other personal and business assets. Many community banks are hungry for new loan opportunities. By combining other personal and business assets as collateral, offering to deposit cash with the bank, introducing new potential customers to the bank, etc., borrowers can greatly enhance their chances of acquiring loans that can be used to effectively refinance existing loans that have impending maturity dates.

In addition, there are a number of private equity funds that have developed in this region designed to take advantage of the problems facing traditional banks. Some of these funds will charge high interest rates and fees but they are an option to otherwise forfeiting a project to foreclosure. Experienced and well-connected practitioners can assist borrowers in finding private equity sources.

5. **Servicer Tips.** Some borrowers must deal with CMBS servicers to discuss a potential loan workout. CMBS loan modi-

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Notes from the Chair

by Timothy C. Burkart – Chair, RPPT Section

It is springtime in the Northwest. It took our legislature two sessions to come up with a balanced budget, but despite the focus on the budget, our section was instrumental in getting remedial legislation passed that has the effect of interpreting tax-based funding clauses in Wills and Trusts of persons who die while the federal estate tax is sleeping and whose documents were drafted prior to 2010 as though it is December 31, 2009. Without this legislation, formula clauses and other dispositive provisions in such person's documents may have resulted in a disposition of their assets that was contrary to their intent. Our section also worked on a number of other pieces of legislation affecting probate and trust practitioners that will likely be reintroduced in the next legislative session.

On the real property side, our section commented on and offered to work with legislative staff members to revise HB2623/SB6694, which would have amended the Deed of Trust Act to prohibit foreclosures on residential property while the borrower was receiving unemployment benefits, and SB 6648, which would have created a new mediation process under the Deed of Trust Act for non-judicial foreclosures on residential property. Our section was concerned that each bill may have had adverse unintended consequences and, where requested, we worked with staff to try to resolve those issues. Ultimately, neither bill was adopted by the legislature in this legislative session. The real property side of our section has formed a new Legislative Advisory Committee to complement the one that has been in existence on the probate and trust side. About 25 highly respected practitioners from around the state agreed to participate and provided valuable input on several pieces of legislation. The hope is that this new committee will deepen the experience that the executive committee brings to its work on legislation. We appreciate the efforts of those who serve on both.

Finally, Congress has yet to act regarding the federal estate tax and now it seems there is a good chance we will all wake up on January 1, 2011, with the pre-Bush tax law in effect. For estate planners, that means, among other things, a $1 million estate tax credit, a 55% top tax rate, return of a full basis adjustment at death, and return of the state death tax credit.

We look forward to seeing you all at our mid-year meeting in Vancouver, Washington, from June 4 to 6.

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fication is a dynamic and fluid process at the moment where the rules and strategies are only now being developed. It is important to know that most CMBS loans are administered by master servicers who have little flexibility in modifying a loan in a mortgage pool because of complex tax rules. Moreover, a master servicer generally defers any possible loan modifications to a special servicer. Until recently, however, borrowers were faced with a circular problem in that they could not discuss a potential loan modification with the master servicer and would not be referred to a special servicer until an actual event of default occurred. Some borrowers were forced to default intentionally by not making a loan payment just to be able to speak with a special servicer. The REMIC rules were recently relaxed by the IRS so as (i) not to penalize mortgage pools for making loan modifications when the servicers reasonably foresee a significant risk of default in the future and (ii) to otherwise allow loan modifications before a loan default occurs. In the current environment, it is also important to know some practical issues at play. Most CMBS loans are administered by a small number of servicers. There are some estimates that 85% of CMBS problems loans are being administered by only 3 servicers. The number of CMBS loans transferred to special servicers within the past year has jumped by nearly 400%. There are reports that the average number of files handled by individuals with authority to modify a loan in the special servicer organization is 300-400. That means a borrower will likely be dealing with an overworked person who has very little time to restructure or even discuss a CMBS loan. Given the recent change in the REMIC rules, borrowers should not intentionally default on their obligations but instead approach the special servicer by describing that the project faces "imminent" default. There are a number of horror stories circulating within the community where servicers immediately foreclosed on assets because a borrower chose to default. Borrowers are probably better off submitting to a special servicer a clear and detailed financial plan outlining the current financial performance of the project, how cash flows can be improved and possible exit strategies that might be implemented if the CMBS loan is extended long enough to give the borrower time to implement a plan. It is generally not possible to create equity kicker and other similar arrangements for a CMBS loan workout, but special servicers are processing loan bifurcation strategies where CMBS loans are split into an A piece and B piece. Typically the B piece is treated more like mezzanine debt subject to a shorter maturity date and higher interest rates. Any loan modification of a CMBS loan involves some complicated "back-door" negotiations among different tranche owners of the mortgage pool but a borrower can process a successful CMBS workout by providing solid financial data for the proposed modification, avoiding loan defaults and offering an A and B piece bifurcation of the mortgage loan. Borrowers who agree to provide additional capital for tenant improvements, working capital, debt service reserves, etc. are getting much greater attention from special servicers who are more inclined to structure longer term extensions of CMBS loans with impending maturity dates.