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Auction planning

Participants urged to be aware of CMBS note sale costs

Increasing adoption of US CMBS note auctions is significant for both noteholders and borrowers. Losses can be considerable and the tax implications for borrowers are not widely understood.

Note auctions have become more widely used this year for US CMBS loan resolutions, having accounted for about US$8bn of the US$84.5bn resolved in 2010 and 2011. By way of comparison, US$12bn of resolutions during the same period was from discounted payoffs, US$8bn from foreclosure and US$10bn was paid off.

"There is a myth in the marketplace that special servicers will always foreclose and do not work loans out, but this is not the case. Special servicers make their decision on the best course of action on a defaulted loan based on what will give the bondholders the highest recovery and least amount of loss," says Ann Hambly, 1st Service Solutions founder and ceo.

Although note auctions have become more popular, they also see high average loss rates. Loss rates for note auctions have been around 50%, with foreclosure REO sales seeing 58% and discounted payoffs generally resulting in losses of around 30%.

"Note auctions have a couple of main benefits. They are quick, so special servicers can earn their fees faster, and they allow the special servicer to have fully-vetted pricing in the marketplace," says Hambly.

She continues: "Many special servicers are using the auction and note sale format because it is the safest way to resolve a deal, even if the losses are higher. If you are going to be second-guessed by bondholders later, it is much harder to question when it has been fully vetted in the marketplace and you have found the highest amount the market would pay."

Lawrence Vo, senior asset manager at 1st Service Solutions, notes that the three largest special servicers service about 75% of the US loans that are in special servicing. He agrees that note auctions are an attractive proposition for special servicers, even if they are not always the best option for noteholders.

"Asset managers within these shops are inundated with loans they have to manage, so it becomes an operational decision to choose the auction format as opposed to an individual asset-by-asset decision," he says. "When you are looking at larger special servicers managing north of US$20bn of loans, they are looking for some sort of clearing mechanism to allow their asset managers – who are looking at a lot of loans – to focus on the loans that have larger losses. So the concept of an auction format or note sale platform for these different servicing shops is a

great tool for them to clear out the deals that really affect the trust a little less than if they could focus on the larger deals in special servicing."

As the note auction process has become more common, it has also changed. Ed Hannon, head of the tax practice at Freeborn & Peters, believes the process is evolving and some of the wrinkles are starting to be ironed out.

He says: "In our experience, the single note auction process is continuing to change. We have seen a few occasions where the documents are so bare-bones or non-existent that it puts the bidder at a disadvantage. Our expectation is that as this process matures, you will see a more typical auction process with all of the documents available in advance of the bid date."

Hannon stresses that the tax implications are vital for any would-be purchaser. Knowing what the tax costs could be and how to plan for them is vital when deciding whether or not to purchase a note and there are ways to minimise the tax cost.

"For US tax purposes, if you are deemed to modify a loan, that can create tax consequences both for the borrower and for the note purchaser. In some instances, a loan modification can cause a note purchaser to recognise gain at the time of the modification. The first issue for a purchaser is avoiding that phantom gain on a restructuring of a loan," Hannon comments.

He continues: "The second issue relates to the borrower and the amount of cancellation of indebtedness income that would arise from a restructuring modification or refinancing of that purchased loan and the proactive ways of deferring that tax – such as the qualified real property business indebtedness election – that allows the borrower to reduce his tax basis in depreciable property, rather than recognise the cancellation of indebtedness income."

Borrowers are not always allowed to purchase their own notes. There have been attempts to work around those restrictions, but Hannon advises borrowers attempting to adopt a work-around structure to be aware of the risks that they are creating and the costs that can be incurred.

"Typically what we are seeing in CMBS auctions is the ability of borrowers to be bidders. In non-CMBS auctions, they are reluctant to have the borrower bid, so we have various structures attempted by bidders to hide the fact that they are the true bidder," Hannon says.

He continues: "You need both economic substance as to who the other party is and if he is merely an alter ego of the bidder – a straw man – then you will have not just US tax consequences, but also consequences under the representations and warranties that you would have to make under the note purchase documents."

Such straw-man purchases will ultimately come unstuck, Hannon adds. How the purchase is resolved is reported under various reporting services, so if an alter ego is used, that fact will come out in time. Ultimately, the more aware participants are of the potential costs associated with note auctions for CMBS loans, the better positioned they will be.

Hannon concludes: "The note purchase transactions are going to become less mysterious as this auction process evolves. It is a mix of real estate due diligence, underlying loan document due diligence and advanced tax planning. If you ignore any of those three issues, your underlying economics and underwriting will not be accurate."

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