

Commercial Real Estate

While commercial mortgages and Commercial Mortgage-Backed Securities (CMBS) have performed relatively well, commercial real estate has nonetheless been tainted by, and now impaired by, the rapid decline in home prices and the problems associated with Residential Mortgage-Backed Securities (RMBS). Conduit financing for commercial real estate has nearly vanished, and traditional portfolio lenders are both cautious and insufficient in number to fill the void. With limited debt available, purchases, sales of and refinancing of commercial real estate, as well as new construction, have all slowed dramatically. As the overall economic picture continues to darken, vacancies in commercial buildings are beginning to rise in many markets, and rents are beginning to decline. Not surprisingly, many are predicting that commercial mortgage defaults will begin to rise.

Against this backdrop, the Emergency Economic Stabilization Act of 2008 (the “Act”) is intended to allow financial institutions to wipe the slate clean and resume lending activity at pre-“crisis” levels. Through the Troubled Asset Relief Program (TARP), the Treasury will purchase “troubled assets” (which term is defined by the Act to include “residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, originated on or before March 14, 2008 as well as and other financial instrument”). This is expected to enable our financial institutions to shift the burden of their troubled assets to the U.S. Department of the Treasury (the “Treasury”) and, in doing so, establish healthier balance sheets and an increased ability to infuse credit back into the market.

Together with the authority to purchase troubled assets, the Act will authorize the Secretary of the Treasury (the “Secretary”) to sell the assets at a later date. As with the sales conducted by the Resolution Trust Corporation (the “RTC”) established by the government in response to the savings and loan crisis of the early 1990s, this will likely create a class of buyers for these assets, which the Treasury hopes will yield a sooner-than-expected return on its investment. In fact, many of these buyers are likely to be private equity funds that trace their origins to the savings and loan crisis and the resulting asset sales by the RTC. Some believe that hedge funds and private equity funds may try to acquire these assets prior to Treasury purchases because they will be able to offer sellers the opportunity to sell the troubled assets without being subject to the executive compensation and corporate governance limitations of the Act. Certainly, some sales of these assets have occurred already.

The Act also requires the Secretary to review the current state of the financial markets and the regulatory system and submit to Congress an analysis of the state of the regulatory system, its effectiveness at overseeing the participants in the financial market, and recommendations for improvement. Presumably, the Secretary will make recommendations to eliminate certain regulatory loopholes, increase market participant transparency, and require lending institutions to improve their credit and appraisal procedures, all of which should restore investor confidence. The RTC's implementation of staunch regulatory oversight and appraisal procedures after the savings and loan crisis was instrumental in the recovery following that period. It is hoped that the Act will yield similar results.

While the desired results are evident, it is much less certain that the law can achieve them. The Act does not yet provide details about the mechanisms for purchasing troubled assets, the methods for pricing and valuing troubled assets, the procedures for selecting asset managers, or the criteria for identifying troubled assets for purchase. Instead, the Act requires the Secretary to later publish program guidelines articulating these details. Once the Secretary publishes program guidelines (required to be published by the earlier of the end of the two-business-day period beginning on the date of the first troubled asset purchase pursuant to TARP and the end of the 45-day period beginning on the date of the enactment of the Act), TARP's impact on commercial real estate and the broader economy will be more certain.

Further, it remains to be seen how many commercial real estate assets will be affected by TARP. Even though "commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages" are included in the definition of "troubled assets," it is not clear what commercial real estate assets will change hands as a result of TARP. If the market-to-market rules are softened, the value of CMBS may not be as severely impacted as RMBS (which would also benefit from a softening of these rules, though perhaps not as much). On the other hand, commercial mortgages and CMBS may come to be viewed as being seriously impaired, in which case broad sales of those assets under TARP may occur as well.

Notably, the Act does contain certain specific provisions that are intended to benefit commercial real estate as an asset class. These provisions were included in the Act to secure its passage and do not relate directly to the economic stabilization aspects of the Act. Chief among them are provisions which will extend expired or expiring tax provisions relating to 15-year qualified leasehold depreciation, brownfields remediation expensing and the energy-efficient commercial building deduction.

- *15-Year Qualified Leasehold Depreciation.* Prior to the American Jobs Creation Act of 2004 (the Jobs Creation Act), Section 168 of the Internal Revenue Code (the IRC) provided that leasehold improvements were depreciated over 39 years for tax purposes. The Jobs Creation Act shortened the recovery period to 15 years for "qualified leasehold improvement property," which includes any improvement made by a lessor or lessee pursuant to or under a lease to the interior of a leased nonresidential property (such as an office building, industrial building, or retail store) placed in service after October 22, 2004 and prior to January 1, 2008, so long as certain other requirements are met. The law extends the shortened recovery period through January 1, 2010.

- *Brownfields Remediation Expensing.* Originally signed into law in 1997 and applicable through December 31, 2007, the Brownfields Tax Incentive (codified at IRC §198) encouraged the cleanup and re-use of brownfields, which are properties where re-use is complicated by environmental contamination concerns. Under the Brownfields Tax Incentive, environmental cleanup costs are fully deductible in the year incurred, rather than capitalized and spread over time. The law renews the Brownfields Tax Incentive through December 31, 2009.
- *Energy-Efficient Commercial Building Deduction.* Section 1331 of the Energy Policy Act of 2005 enacted Section 179D of the IRC, which provides a deduction with respect to energy-efficient commercial buildings. Section 179D(a) allows a deduction to a taxpayer for part or all of the cost of an energy efficient commercial building property that the taxpayer places in service after December 31, 2005 and before January 1, 2008. The law extends the Energy-Efficient Commercial Building Deduction through December 31, 2013.

While the extension of these tax provisions will clearly benefit commercial real estate, the effect of the more publicized economic stabilization provisions of the Act on commercial real estate are less clear. Certainly, a resumption of any meaningful lending activity would be beneficial to the commercial real estate industry. In addition, if the Act restores investors' confidence in all asset classes, then the commercial real estate industry, as well as the rest of the economy, will benefit, and the Act will be judged a success.

The attorneys at Morgan Lewis have broad experience in all aspects of commercial real estate, including loan restructuring and work-outs and sales and purchases of distressed real estate and loans. We are ready to assist our clients in these matters.

If you have any questions or would like more details concerning any of the points mentioned in this discussion briefing, please contact the Morgan Lewis attorney with whom you normally communicate or any of the Morgan Lewis attorneys in our Financial Crisis Working Group:

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