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The CMBS wave finally hits Switzerland

Switzerland has seen a dramatic increase in both origination and securitisation activity in the commercial real estate market over the past 18 months. New foreign lenders and sponsors are entering the Swiss market. It may be expected that 2006 will show another significant increase in Swiss CMBS issue volumes. We are likely to see future multi-jurisdictional and pan-European deals, including Swiss assets from both existing CMBS conduits and an increasing number of new conduits by new CMBS lenders. The following article provides an overview on Swiss legal and tax issues in this new market segment.

Securitisation has found legal and commercial acceptance in Switzerland without the benefit of legislation or regulations specifically governing the issuance of asset-backed securities. A series of public and private transactions since 1994 have produced a tried-and-tested securitisation transaction structure in which a trustee issues securities to investors, loans the proceeds on an unsecured basis to a special purpose Swiss corporation, which in turn acquires the relevant assets and engages the originator to service them. The first public transaction based on this structure was "Tell", a residential mortgage securitisation which came to the market in 1998 and was originated by Swiss Bank Corporation (today UBS AG).Other public transactions modelled on this structure are "Swissact" - a residential mortgage securitisation originated by Zürcher Kantonalbank in 2001 - and "Eiger", a commercial real estate mortgage securitisation in 2003 originated by the Swiss branches of two Bermuda companies controlled by a Lehman Brothers real estate fund. Over the past two years CMBS conduit lending became popular in Switzerland and two Pan-European CMBS transactions of Deutsche Bank AG including Swiss loans have come to market in 2005 and 2006. Other CMBS lenders are working on the establishment of similar CMBS conduit platforms to securitise their Swiss loans.

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Typical Swiss CMBS securitisation structure

In the typical Swiss CMBS securitisation structure, the loans and their related security are, in the first step of the transaction, sold by the originator to an insolvency–remote special purpose vehicle organised in Switzerland (the "Swiss vehicle"). The sale of loans and their related security by the originator to the Swiss vehicle constitutes a true sale, insulating the relevant assets from the insolvency-risk of the originator and may be undertaken without any onerous transfer formalities or expenses. The Swiss Vehicle funds the purchase of the loans and their related security by way of an unsecured loan from the ultimate issuing vehicle, which is typically organised outside Switzerland (the "non-Swiss vehicle"), the unsecured loan being the second step of the transaction structure. The non-Swiss vehicle is the issuer of the debt instruments.

Swiss mortgage security

In Switzerland, security for the repayment of a loan used for the purchase of real estate is generally created by the obligor executing a "Schuldbrief" and delivering it to the lender. The Schuldbrief is independent evidence of the obligor's debt and it is usually recorded in a public land register as an encumbrance on the relevant property.

The Schuldbrief is usually issued to the obligor in bearer form and the security interest is created by the obligor delivering the Schuldbrief to the lender pursuant to a security assignment (Sicherungsübereignung). If the Schuldbrief

has been issued in registered form, then it also must be endorsed by the obligor in favour of the lender. The security assignment gives the lender the power to seek what is tantamount to the sale of the property in foreclosure proceedings if the obligor defaults on its obligations.

The lender/originator in a commercial or residential real estate securitisation will also make a security assignment to the purchaser in the ABS transaction of each Schuldbrief which was delivered pursuant to a security assignment made by an obligor to the lender/originator when the relevant loans were originated. Careful structuring is needed to ensure that the purchaser has taken delivery of the Schuldbriefe securing real estate loans in an ABS transaction and that any servicer may take possession of the Schuldbriefe when needed for debt enforcement purposes.

Security agent structure

CMBS conduit programmes are increasingly making use of mezzanine or subordinate B note structures, a trend that seems largely driven by the strong appetite of an increasing pool of investors seeking such mezzanine or subordinate B notes. This often takes the form of a single loan which is tranched into a senior and a junior piece, together secured by a single security package (A/B loan structure).

Instead of a security trustee and parallel debt structure, it is recommended using a security agent structure to deal with syndication and/or securitisation at the security level. Under Swiss law, the security agent does not acquire its own legal rights in relation to the security interest as he only acts on behalf of the lender(s)/finance parties which appoint the security agent as their representative. The enforcement of security interest by the security agent requires the proof of its appointment and the further evidence that the lender(s)/finance parties may begin such enforcement proceedings as set out in the provisions of the respective agreements between the lender(s)/finance parties and the borrower, as the security agent does not enforce any own claims or rights. There is, in general, no need to amend the security documentation or registrations in case of securitisation or syndication.

Also, a registration of transfer of the mortgage notes in a public register is not necessary. However, registration in the so-called Gläubigerregister, evidencing the creditor of the mortgage note, may be effected (in a few Swiss cantons, such registration is not recommended as it may cause additional taxes), but does not affect the rights of the secured party nor is an amendment required in the event of the appointment of a security agent.

Benefits of Swiss Merger Act for real estate portfolio transactions

The Swiss Merger Act ("SMA"), entered into force as of 1 July 2004, provides a new and potentially more cost-efficient possibility in relation to the transfer of title of real estate portfolio transactions. Based on the provisions contained therein, a company or a private firm, registered in the commercial register, is allowed to transfer all of its assets and liabilities, or parts thereof, by way of one single act - the so-called universal succession - to another legal entity.

Form and content of transfer agreement

The transfer agreement needs to be concluded in written form. However, if - as in this context is relevant - the assets consist of one or more properties owned by the transferring company, the provisions relating to the acquisition of such property in the transfer agreement must be established in the form of a public deed. Based on the understanding in the Swiss doctrine, contractual provisions relating to the contractual parties, the assets to be transferred (eg the definition of the real estate), the part of consideration applicable to the transferred properties, contractual provisions that refer to the properties and all other provisions that may be considered relevant as regards the transfer of the properties need to be notarised. This allows the parties only to disclose parts of the transfer agreement; nevertheless, it has to be carefully considered if a notarisation of all provisions of the transfer agreement is preferable or even required, as this could prevent the parties from subsequent discussions whose provisions would have to have been notarised. Indeed, if a transfer of properties is the main purpose of the transfer agreement, the whole agreement has to be notarised.

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Inventory

In any case, the transfer agreement has to contain an inventory - specifically determining the assets and liabilities - transferred between the parties; if real estate shall be transferred, exact information of the land register in relation to all properties involved are required. In any case, the inventory may only contain such assets that are capable to influence the asset position in the balance sheet; as a consequence, items such as goodwill could not be part of the inventory. This may become relevant as the so-established inventory, including all assets, needs to reveal a net surplus.

Prerequisites of conclusion of transfer agreement

The conclusion of the transfer agreement does not require a resolution of the shareholders or partners of the transferring company, approving the transfer of the assets. However, the shareholders or partners have to be informed about the transfer, be it at a general meeting or in the annex to the annual statements and reports.

The transfer of the assets itself has to be executed by the highest executive bodies of all the entities involved in the transfer; eg in case of corporations, by the members of the board of directors of both transferring company and receiving company. In addition, the highest executive body of the transferring company needs to apply for registration of the transfer with the commercial register.

Jurisdiction of notary

If a notarisation of the transfer agreement is required in case of transfer of real estate, the notary at the domicile of the transferring company is competent to execute such notarisation. The advantage of this regulation becomes evident if more than one property shall be transferred: before the Swiss Merger Act came into force, notarisation of the agreement, transferring the ownership of a property (such as a sale and purchase agreement) had to be effected at the location of every single property (bearing in mind minor sectors of competences of the Swiss notaries involved). Consequently, several public deeds were required - with every deed causing its own notarisation fees - if several properties had to be transferred. Under the new provi-

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sions of the Swiss Merger Act, only one public deed is required and consequently, the notarisation fees have to be paid only once.

Time of effectiveness of the asset transfer
The transfer of assets becomes legally effective upon registration of the transfer in the relevant commercial register; eg all assets that are evidenced in the inventory as part of the transfer agreement are transferred to the acquiring entity by operation of law. Therefore, no further action is required from any of the parties. The application to the commercial register needs to be accompanied by the transfer agreement and the resolution of the board of directors of the companies, approving the transfer, provided that the transfer agreement has not been signed by all members of the board of directors.

Under Swiss law, the acquisition of ownership of real estate is basically bound to the prerequisite of the entry of the new owner in the relevant land register. Contrary to that and with entry into force of the new provisions of the Swiss Merger Act, ownership already passes over at the time of entry of the transfer agreement in the commercial register, whereas the still-required subsequent entry of the new owner into the land register bears only declaratory meaning. In order for the land register to be notified of the change of ownership, the party acquiring the real estate needs to promptly inform the land register about such a transfer. The prompt entry of the new owner into the land register is essential, as third parties - acting in good faith and relying on the information of the transferring party still being the registered owner of the property - may acquire ownership as long as the modification of the registration in the land register has not been effected.

Tax

The following tax considerations need to be addressed in a typical CMBS transaction involving Swiss loans. It is important that advance tax ruling confirmations can be obtained from the various competent tax authorities to ensure that no adverse tax consequences arise in connection with the origination and securitisation of Swiss loans.

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Federal withholding tax and stamp duties on instruments of collective fund raisings
Instruments of collective (debt) fund raisings issued by a Swiss tax resident borrower or by a foreign tax resident borrower having a registered branch office in Switzerland trigger Swiss stamp duties on the principal of the debt instruments issued and a 35% Swiss federal withholding tax on interest payments (including original issue discounts and premiums). A company becomes a Swiss tax resident either if it is incorporated under the Laws of Switzerland or if it is effectively managed and controlled in Switzerland.

In order to provide certainty that no collective fund raising is given and that interest payments made by the borrower do not trigger the Swiss Federal withholding, care must been taken in the credit agreement to introduce appropriate transfer restrictions on the lenders that no collective fund raising is given from the outset and that no collective fund raising may occur over the term of the agreement (the so-called "10 Non-Qualifying Bank Creditor" and "20 Non-Qualifying Bank Creditor" limitations).

With regard to the 35% Swiss Federal withholding tax on interest payments on instruments of collective fund raisings, it is uncertain whether a gross-up would be valid and enforceable under Swiss law. However, the Swiss Federal Tax Administration (hereinafter "FTA") has taken the position that provisions for interest gross-ups may be upheld if all of the following criteria are met: (i) the borrower has promised in the interest clause of the agreement (and not only in the tax clause included in the agreement) a minimum interest rate (net interest amount) to be adjusted accordingly under the condition that withholding taxes, if any, are imposed; (ii) that withholding taxes imposed, if any, are calculated and retained on the basis of the grossed-up interest amount due and payable; (iii) that the borrower makes available to the lender the documentation needed for a refund of withholding taxes, if any; and (iv) that at the time of entering into the agreement the parties could in good faith assume that payments under the agreement were not subject to withholding taxes. However, a Swiss court rul-

INFORMATION

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ing on the validity or enforceability of gross-up provisions will - even if the conditions set out by the Swiss FTA mentioned above are met - not be bound by the Swiss FTA's interpretation of the law and may therefore still consider any gross-up provision as null and void.

Special interest withholdings on mortgaged loans
Interest payments on loans secured by a mortgage, a mortgage note or other rights in relation to Swiss real estate property are subject to a special federal and cantonal (state) withholding tax if such interest payments are made to a lender not being a Swiss resident or not maintaining a Swiss permanent establishment to which such interest payments are attributable. In general, the aggregate federal and cantonal special withholding tax rate is between 17% and 23%, depending on the canton where the real estate property is located. If the non-Swiss resident lender is eligible for the benefits of a double tax treaty concluded with Switzerland, such special interest withholding may be reduced at source to the applicable treaty rate or even eliminated. With regard to special interest withholdings on mortgaged loans, no special limitations on the validity and enforceability of interest gross-up provisions apply.

Local capital gains and transfer taxes, stamp duties
In some of the cantons, capital gains realised by a seller on the transfer of real estate property held as a business asset is subject to a special real estate capital gains tax. In general, the seller is accountable and liable for such tax. However, if the tax remains unpaid, the competent local tax authorities may put a lien on the real estate property transferred which may have priority on other security interests created on such property.

In order to avoid such a lien being attached to the real estate property acquired by the borrower, care must be taken that the sale and purchase agreement provides that a portion of the sale price is put in escrow for the settlement of the capital gains tax triggered on the sale or that a security is provided by the seller that such tax will be paid upon first demand.

The transfer of real estate property may be subject to local transfer taxes, registration or other duties. The creation of a mortgage interest, a mortgage note or any other real estate property security interest or the transfer of such a security interest may be subject to local transfer taxes, registration or other duties. Local law may provide that such taxes and duties are borne by the seller, by the buyer, by the transferor or transferee of a security interest or that a split of these taxes, registration or other duties among the seller, the buyer, the transferor or the transferee applies.

A few cantons (for example, Baste City, Geneva, Valais, Vaud and Ticino) levy a separate stamp duty on certain instruments and documents, such as written debt recognitions, certain contractual agreements, the issuance or transfer of certain security instruments and the filing of certain documents or instruments with a local court or public body.

Thin capitalisation
The Swiss thin capitalisation rules apply if, and only if, financing is provided by a lender being a related party to the borrower. In general, a related party financing is assumed if the parent or any other upper tier company is providing financing to its subsidiary or affiliate respectively. Further, a (constructive) related party financing may be assumed, if a third party is providing financing and if such a third party may benefit from a guarantee or other security from the parent or any other upper tier company related to the borrower (down stream security).