DechertOnPoint

September 2009 / Issue 25

A legal update from Dechert's Finance and Real Estate Group

# Internal Revenue Service Issues New REMIC Rules Regarding Mortgage Loan Modifications

**At a Glance**

- PSA limitations on Master Servicers' and Special Servicers' abilities to modify loans may mute the effect of some of the relaxed tax law REMIC requirements.
- Master Servicers may be inundated with requests for loan modifications from borrowers that they will be contractually unable to grant.
- Special Servicers may be beset with many requests for consent to loan modifications to be made by Master Servicers.
- Borrowers of performing, non-troubled loans will enjoy greater flexibility for modification.
- New requirement for retesting collateral value may prohibit some loan modifications.
- Some loan modifications and all real property lien releases now require retesting to ensure mortgage loan continues to be "principally secured by an interest in real property."
- Retesting collateral value may create direct conflict between borrowers' contract rights and REMIC compliance.

## Introduction

The IRS released on September 15, 2009 (i) Revenue Procedure 2009-45 (the "Revenue Procedure"),[1] permitting, under certain circumstances, the modification of mortgage loans held in REMICs that present a "significant risk of default," and (ii) final regulations (the "Regulations"),[2] permitting certain modifications of collateral, guarantees and other credit enhancement for mortgage loans held in REMICs.[3] The Revenue Procedure and the Regulations represent a significant loosening of certain restrictions on the modification of mortgage loans held in REMICs contained in Section 860G of the Internal Revenue Code and the regulations thereunder (the "REMIC Rules"). This *DechertOnPoint* poses and answers questions regarding the practical effect of the Revenue Procedure and the Regulations on CMBS industry participants, with a focus on Master Servicers and Special Servicers.

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1 www.irs.gov/pub/irs-drop/rp-09-45.pdf.

2 http://edocket.access.gpo.gov/2009/pdf/E9-22215.pdf.

3 For purposes of this article (i) the Internal Revenue Service is referred to as the "IRS," (ii) real estate mortgage investment conduits are referred to as "REMICs," (iii) pooling and servicing agreements are referred to as a "PSAs," (iv) the master servicer appointed under a PSA is referred to as the "Master Servicer," (v) the special servicer appointed under a PSA is referred to as the "Special Servicer," and (vi) references to the "Servicer" mean the Master Servicer or the Special Servicer, as applicable.

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## General Questions Regarding the New Rules

**What is the difference between a ''Revenue Procedure'' and ''Regulations''?**

A revenue procedure is an IRS statement of procedure that affects the rights or duties of taxpayers or other members of the public under the Internal Revenue Code and related statutes. Revenue Procedures often announce IRS practices and procedures and provide guidance to taxpayers. The IRS is generally free to promulgate, amend or rescind revenue procedures at its discretion.

Regulations are issued by the Treasury Department in conjunction with the IRS and generally implement rules for interpreting or administering statutory provisions. Regulations may only be promulgated after notice to and comment and input from the public is given and received. These notice and comment procedures must also be followed when modifying or rescinding regulations.

Regulations are accorded greater deference than revenue procedures by the courts. The legal distinction between a revenue procedure and a regulation, however, will not be material for the purposes of most industry participants facing loan modification issues.

**When are the new rules effective?**

The Regulations apply to loan modifications made on or after September 16, 2009. The Revenue Procedure applies to loan modifications effected on or after January 1, 2008.

## Questions with Respect to Revenue Procedure 2009-45

**In summary, what does the Revenue Procedure provide?**

Previously, the REMIC Rules generally prohibited any "significant modification" of a mortgage loan, with specified exceptions. Before amendment, the REMIC Rules provided exceptions from the general prohibition for certain modifications, including those occasioned by a mortgage loan default or a "reasonably foreseeable" default.

Under both the old rules and the new rules, any significant modification that doesn't fall within an exception will be treated as an exchange of the pre-modification mortgage loan for a new modified mortgage loan, and may cause the REMIC to lose its REMIC qualification status under the REMIC Rules.[4]

The new Revenue Procedure effectively expands the exception for modifications of mortgage loans occasioned by a "reasonably foreseeable" default. The IRS now will treat the exception for modifications of mortgage loans occasioned by a reasonably foreseeable default as including any mortgage loan that the Servicer determines has a "significant risk of default." Generally, a Servicer can now modify a mortgage loan at significant risk of default without violating the REMIC rules, although if the modification includes a release of lien, the mortgage loan will be required to satisfy a test designed to assure that the mortgage loan will continue to be treated as principally secured by real property (see a more detailed discussion of this test, below).

**What was the IRS's motivation in publishing the Revenue Procedure?**

The Revenue Procedure speaks directly to issues facing CMBS industry participants in the current economic climate. The Revenue Procedure indicates that the IRS was responding to many industry participants' belief that a modification could not be occasioned by a default or a reasonably foreseeable default unless the mortgage loan was actually in default or default was imminent. The IRS effectively expanded the list of circumstances under which modifications would be permissible without adverse REMIC tax consequences to include loans with a significant risk of default.

**Does the more expansive ''significant risk of default'' exception contained in the Revenue Procedure apply to all mortgage loans held in REMICs?**

No. The Revenue Procedure applies only to REMIC mortgage loans that meet four criteria:

- the mortgage loan must not be secured by a residence that (i) contains fewer than five dwelling units, and (ii) that is the borrower's principal residence;
- with respect to the REMIC holding the mortgage loan, as of the end of the 3-month period beginning on the startup day of the securitization, no more than 10% of the stated principal of the total

4 A loss of REMIC status would often cause the securitization structure to be treated as a taxable mortgage pool, with taxes imposed on the securitization vehicle and potentially catastrophic consequences to investors as a result of tax leakage.

assets of the REMIC was represented by mortgage loans that, at the time of contribution to the REMIC, were delinquent by at least 30 days or for which a default was reasonably foreseeable;[5]

- based on all the facts and circumstances, the Servicer reasonably believes that there is a *significant risk of default* of the mortgage loan upon maturity or at an earlier date; and
- based on all the facts and circumstances, the Servicer reasonably believes that the mortgage loan, as modified, presents a *substantially reduced risk of default*.

**What factors must a Servicer consider when determining if a mortgage loan is in "significant risk of default"?**

The Revenue Procedure provides that the Servicer's belief that a mortgage loan is in significant risk of default must be based on the Servicer's own diligent determination taking into account all relevant facts and circumstances. Although not required, the Servicer is expressly permitted to rely on a credible written representation from the borrower that there is a significant risk of default with respect to the mortgage loan, provided that the Servicer has no reason to believe that representation is false.

**Can a Servicer consider market conditions and refinancing risk in determining that a mortgage loan poses a significant risk of default?**

Yes. The IRS expressly recognized that, for the majority of commercial mortgage loans, the primary source for principal repayment at maturity are proceeds from refinancing. The IRS also conceded that current market conditions have greatly affected borrowers' abilities to refinance mortgage loans that will mature in the next few years, and that a reduced ability to refinance even applies to mortgage loans that are generating sufficient cash flow to satisfy monthly debt service. The prospective inability of a borrower to refinance a mortgage loan (even if it is currently performing) may be a determining factor informing a Servicer's reasonable belief that a mortgage loan poses a significant risk of default.

5 Note: The Revenue Procedure provides for a separate test for mortgage loans held by investment trusts taxed as grantor trusts, which we do not address in this article.

**Can a Servicer determine that a performing mortgage loan is in significant risk of default even if the mortgage loan is far from maturity?**

Yes. As noted above, the prospective inability of a borrower to refinance a mortgage loan at maturity may be a determining factor informing a Servicer's reasonable belief that a mortgage loan presents a significant risk of default. The Revenue Procedure does not place an outside time limit on foreseeability of default for a Servicer's determination that a mortgage loan presents a significant risk of default (although how far into the future a prospective default may occur is a relevant factor to be considered). The Revenue Procedure provides that that there is no maximum period after which default is *per se* not foreseeable. Under certain circumstances, a Servicer may reasonably believe that a significant risk of default exists even if the foreseen default is "more than one year in the future."

**Can a mortgage loan be in significant risk of default even if it is performing and can be reasonably expected to perform until maturity?**

Yes. The Revenue Procedure provides that the Servicer, in appropriate circumstances, may determine that a loan that is expected to perform up to maturity is in significant risk of default. These circumstances may include a mortgage loan that continues to perform despite weakening fundamentals as a result of the application of debt service reserves. Another example may include a performing mortgage loan that, due to a steep decline in fair market value, will not be able to be generate sufficient sale or refinancing proceeds to satisfy the principal balance of the mortgage loan at maturity.

**If a mortgage loan is in significant risk of default and the Servicer wants to modify the loan, does the modification itself have to meet any guidelines?**

Yes. Only a modification that the Servicer reasonably believes will cause the modified loan to have a *substantially reduced risk of default* is included in the scope of the Revenue Procedure's guidelines. This determination must be made by the Servicer based on all of the facts and circumstances present with respect to the mortgage loan. Modifications that do not substantially reduce the risk of default will not meet the requirements of the Revenue Procedure.

## Questions Regarding the New Regulations

**What was the IRS's motivation in adopting the new Regulations?**

In March 2007, the IRS solicited input on the need for regulatory amendment relating to the prohibitions on modifications of REMIC-held loans.[6] The Regulations represent the completion of the amendment process. The Regulations were not occasioned by, and are not intended to be reactive to, the current credit crisis.

**How do the Regulations affect what modifications can be made to a loan?**

The Regulations greatly expand the list of permitted exceptions for modifying mortgage loans. The Regulations now permit:

- changes in collateral;
- changes in guarantees;
- changes in credit enhancement; and
- changes to the recourse nature of mortgage loans.

These new exceptions apply, however, only to the extent one of two tests is met. These tests are described below.

**Assuming that the provisions of a PSA permit the Servicer to make a modification, what are some examples of modifications that are now permitted by the new Regulations?**

Examples of newly permitted loan modifications include:

- Release of a property in a multi-property loan in connection with a sale of that property in exchange for a partial principal pay-down;
- Collateral substitution of a better-performing property for an under-performing property;
- Addition of new real property collateral;
- Release, replacement or modification of loan guarantors or guaranties; and
- Release, replacement or modification of letters of credit or cash reserves.

There are many more examples (and variations of these examples) of situations to which the new loan modification rules might apply.

**Is there a limitation on the ability of a Servicer to enter into these newly permitted modifications?**

Yes. The Regulations now require that modified mortgage loans (as well as any mortgage loans subject to a lien release) be retested to ensure that the mortgage loan continues to be principally secured by real property. This is a significant new limitation on the ability of Servicers to modify mortgage loans and administer lien releases and is described more fully below.

**Didn't the old REMIC Rules already require that the mortgage loan be principally secured by real property?**

Yes. The old REMIC Rules included a requirement that the fair market value of the real property serving as collateral for a mortgage loan equal at least 80% of the principal amount of the mortgage loan (the "80% Test"). However, the REMIC Rules previously only required the 80% Test to be satisfied either *at origination or upon contribution* to the REMIC. Prior to the new Regulations, there was no subsequent requirement to apply the 80% Test.

**When do the new Regulations require retesting to determine that the mortgage loan continues to be principally secured by real property?**

The new Regulations require that any mortgage loan that is modified under the new exceptions or any mortgage loan that releases a lien on real property securing mortgage loan be retested to ensure that it continues to be principally secured by real property, irrespective of whether the release of lien is in connection with a significant modification.

**Why do the Regulations now require that real property collateral value be retested?**

The IRS determined that because certain loan modifications could affect the underlying value of the real property collateral, the value of the real property should be retested to ensure that the mortgage loan is still principally secured by real property, a fundamental REMIC requirement, and that modifications that result in a mortgage loan failing the principally-secured test should not be permitted. Furthermore, the Regulations

6 Notice 2007-17 (2007-1 CB 748 (March 19, 2007)).

also now apply the retest to all situations involving a release of a lien on real property, including those that do not represent a significant modification of the mortgage loan.

**How does a Servicer determine if a modified loan continues to be principally secured by real property?**

The Regulations require one of two tests to be met. The Regulations provide that a mortgage loan continues to be principally secured by real property if *either*:

- the 80% Test is satisfied; or
- the fair market value of the real property collateral immediately after the modification equals or exceeds the fair market value of the real property collateral immediately before the modification (the "Equivalent Value Test").

**If a borrower has a unilateral option to obtain a release of lien under its mortgage loan documents, but the real property remaining after giving effect to such release cannot satisfy either the 80% Test or the Equivalent Value Test, can the Servicer release the lien of the mortgage without violating the new REMIC Rules?**

No. Even in situations where a borrower has a unilateral right under the mortgage loan documents to obtain a release of lien, the Regulations require that the mortgage loan continues to be principally secured by real estate. Therefore, the lien release will violate the Regulations unless either the 80% Test or the Equivalent Value Test is met. In all but a few cases, the fair market value of the real property securing the mortgage loan prior to the release will be more than the fair market value of the real property securing the mortgage loan after the release, violating the Equivalent Value Test. This is a particularly significant development for multiple-property portfolio loans containing release provisions and many retail-center loans containing releasable "outparcels."

It should be noted that a release of a *de minimis* amount of real property collateral might be viewed not to reduce the value of the remaining collateral (for example, a release of an easement that does not diminish the value of a commercial property because the easement was neither used nor expected to be used in connection with the development or operation of the property).

**Is a new appraisal required when determining if a mortgage loan continues to be principally secured by real property?**

No. The Regulations do not require the Servicer to obtain a new appraisal in conducting the test, although obtaining an appraisal may be the best basis in many situations for determining whether a loan meets the "principally secured by real estate" tests. Instead, the Regulations permit the Servicer to base its value judgment on a sale of the property to a third party (for example, in connection with an assumption of the mortgage loan) or some other commercially reasonable valuation method.[7]

## Questions Regarding the Effect of the New Rules on Master Servicers

**What impact will the Regulations and the Revenue Procedure have on Master Servicers?**

Because the changes effected by the Regulations and the Revenue Procedure have been widely publicized as permitting greater flexibility for Servicers to modify mortgage loans held in REMICs, Master Servicers will likely see a substantial uptick in requests for modifications from borrowers facing current operating issues or future refinancing risk. The modifications to the REMIC Rules, however, do nothing to expand the scope of the Master Servicer's authority under the PSA. PSA provisions differ widely in granting Master Servicers and Special Servicers the right to modify non-specially serviced loans. In some cases, the Master Servicer may be prohibited by the PSA from modifying loans, notwithstanding the fact that the contemplated modification would be permitted under the revised REMIC Rules. In other cases, the Master Servicer may be permitted to effect certain modifications with the consent of the Special Servicer. The Special Servicer may also be permitted by the terms of the PSA to modify mortgage loans prior to the mortgage loan becoming specially serviced. What modifications the Master Servicer can enter into must be determined on a case-by-case basis after careful consideration of the provisions of the PSA.

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7 It is not clear, however, which specific valuation methods will be viewed to be commercially reasonable. One question generating significant interest at this time is whether broker valuations will be accepted as a commercially reasonable basis.

**Will the Regulations and the Revenue Procedure make it easier for borrowers to obtain modifications for troubled mortgage loans?**

Maybe. Before the rules were amended, borrowers with troubled loans faced two hurdles under many PSAs. The first hurdle was that the REMIC rules did not give Servicers much flexibility to modify their loans, and that problem has been addressed in the new REMIC changes. The second hurdle is that Master Servicers are sometimes contractually restricted in their ability to modify mortgage loans under the provisions of the PSA. This latter problem has not been addressed, and, as discussed above, PSAs widely differ with respect to granting authority to modify mortgage loans.

**Do the changes presented by the Revenue Procedure mean that a Master Servicer can modify mortgage loans upon finding a "significant risk of default"?**

It depends. The Revenue Procedure deals exclusively with the tax law prohibitions contained in the REMIC Rules, and does not amend or modify the terms of PSAs or other contractual arrangements. If the PSA does not permit the Master Servicer to modify a mortgage loan, the relaxation of the REMIC Rules will not grant Master Servicers any greater authority to modify mortgage loans.

**Do PSAs generally permit Master Servicers to modify mortgage loans?**

Common industry PSA forms differ greatly on this issue. However, in our experience, PSAs generally fall into one of four discernable categories with respect to their treatment of the modification of mortgage loans that have not been transferred to special servicing:

- the PSA provides that the Master Servicer is permitted to modify the mortgage loan;
- the PSA provides that the Master Servicer is permitted to modify the mortgage loan with the consent of the Special Servicer;
- the PSA provides that the Special Servicer is permitted to modify the mortgage loan prior to it being transferred to special servicing; or
- the PSA prohibits the Master Servicer from modifying the mortgage loan and prohibits the Special Servicer from modifying mortgage loans that have not been transferred to special servicing.

It is imperative that Servicers review the applicable PSA when considering the request for a modification of a mortgage loan.

**If neither the Master Servicer nor the Special Servicer is permitted to modify mortgage loans under the terms of the PSA, does the Revenue Procedure have a practical effect?**

No. The PSA, and not the Revenue Procedure, will govern if a Servicer has the authority to modify a mortgage loan. If the PSA does not permit the Master Servicer (with or without Special Servicer consent) to modify a mortgage loan and does not permit the Special Servicer to modify a mortgage loan prior to it being transferred to special servicing, the Revenue Procedure will have no practical effect.

## Questions Regarding the Effect of the New Rules on Special Servicers

**Do the Regulations affect loans that have already been transferred to Special Servicing?**

Perhaps. Special Servicers ordinarily assume responsibility for servicing loans that are in default or for which default is imminent. These mortgage loans already may be modified under the existing REMIC Rules (the REMIC Rules allow modifications of defaulted loans and loans where a default is "reasonably foreseeable"). Therefore, the changes instituted by the Regulations should not have a noticeable impact on a Special Servicer's ability to modify specially serviced mortgage loans. However, any mortgage loan modification effected by the Special Servicer that includes a release of lien must now meet the "principally secured by real estate" test described above.

**Do the "significant risk of default" changes presented by the Revenue Procedure mean that loans will be transferred to special servicing earlier than in the past?**

No. The Revenue Procedure has no effect on the provisions of PSAs that determine when mortgage loans are transferred to special servicing.

**What impact will the changes set forth in the Revenue Procedure have on Special Servicers?**

The impact may be limited. Because PSAs generally only provide for special servicing when a mortgage loan is in default or default is imminent, the relaxation of the REMIC Rules will not result in any change to the Special

Servicer's ability to modify specially-serviced loans.[8] However, if a Master Servicer is permitted by the PSA to modify mortgage loans, the changes set forth in the Revenue Procedure may result in mortgage loans being modified before being transferred to special servicing. In these cases, if Master Servicer modifications are successful in avoiding default, loans might avoid going into special servicing and the Special Servicer may not earn special servicing fees or workout fees with respect to that mortgage loan. In addition, if the Master Servicer is permitted by the PSA to modify mortgage loans with the consent of the Special Servicer, the Special Servicer should expect to see a significant increase in requests for consent.

## Examples

**A borrower under a fully performing, non-defaulted multi-property mortgage loan requests the waiver of a debt service coverage test that is a condition to a property release. Do the expanded exceptions contained in the Regulations permit the Master Servicer to effect such a modification?**

It depends. First, the Master Servicer must determine if it is authorized under the applicable PSA to effect such a modification. If the Master Servicer has that authority, and if the Master Servicer determines that the mortgage loan, after giving effect to the property release, will continue to be principally secured by real property, the Master Servicer will be able to effect the property release under the REMIC Rules.

**A borrower under a currently performing, non-defaulted loan expects that, due to a steep decline in property value, it will be unable to refinance the mortgage loan on the maturity date. Will the changes to the REMIC Rules help the borrower obtain an extension of its loan?**

Maybe. Although the mortgage loan may be in significant risk of default pursuant to the expanded interpretation set forth in the Revenue Procedure, the Master Servicer may be prohibited by the PSA from entering into modifications extending the maturity date of the mortgage loan. Furthermore, because the mortgage loan is not in default and default is not imminent, the mortgage loan may not be able to be transferred to the Special Servicer. The changes to the REMIC Rules will not assist a borrower under these circumstances.

**A borrower under a performing, non-defaulted multi-property loan has the right under its loan documents to obtain a release of a property upon the occurrence of certain conditions, all of which have been met. Due to a steep decline in the value of the collateral portfolio, the real property value-to-loan ratio is now less than 80% (i.e., the 80% Test is not met). Can the Master Servicer release the lien of the mortgage from the released property without violating the REMIC Rules?**

No. Because the 80% Test will not been met, the property can only be released if the Equivalent Value Test can be met. The Equivalent Value Test cannot be met because the fair market value of the remaining real property immediately prior to the release will be greater than the fair market value immediately after the release. Therefore, the mortgage loan would not continue to be principally secured by real property and the collateral release would violate the terms of the Regulations.

**A borrower under a performing, non-defaulted loan has the right under its loan documents to substitute the collateral property for another property upon the occurrence of certain conditions, all of which have been met. Due to a steep decline in the value of the collateral portfolio, the real property value-to-loan ratio is now less than 80% (i.e., the 80% Test is not met). Can the Master Servicer release the lien of the mortgage from the released property without violating the REMIC Rules?**

Perhaps. Because the 80% Test will not been met, the lien of the existing property can only be released if the Equivalent Value Test can be met. If the substitute property is of equal or greater value than the property that will be released, the Equivalent Value Test will be met and the mortgage loan will qualify as continuing to be principally secured by real estate. In that case, the substitution should not violate the terms of the Regulations.

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8 Note, however, that to the extent the modification includes a release of lien, the Regulations require that the mortgage loan continue to be principally secured by real estate.

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