

PICKING UP THE PIECES:

**A Lender's Guide to Analysis of
Workouts and Restructurings of
Distressed Commercial Real Estate Loans**

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1st Edition: November 2009

Originally prepared as part of a seminar included in the Executive Education Programs presented by the Harvard University Graduate School of Design

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FOREWORD

While there are numerous publications about the current downturn, we've decided to look at the basics. We have tried to provide a straightforward introduction to the issues with an emphasis on how they can affect workout decisions. At the end of the day, however, any workout or restructure is about the property, including the management. We've tried to create a framework to help lenders assess what they have and achieve the best possible result.

The presence of Mezz lenders, subordinate tranches, servicers or syndicate members in a particular transaction will of course complicate matters. To get something done, you may have to compromise; you may have to change course and the necessary negotiating skills may be more about consensus building than getting the best deal from the borrower. In any event, the process must start with clear and objective pictures of the state and prospects of the property, and the formulation of reasonable economic objectives.

We hope this is helpful.

Sheri and Tim

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By Sheri P. Chromow and Timothy G. Little¹

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- 1 These materials were originally prepared as part of a seminar included in the Executive Education Programs presented to the Harvard University Graduate School of Design.
 - 2 As issues in Distressed Real Estate are rapidly evolving, these materials will be updated from time to time as developments warrant.

I. INTRODUCTION

The following chapters provide a brief guide to issues raised when confronting distressed commercial real estate loans. The guide is written from the Lender's perspective and attempts to combine an analysis of the legal issues affecting troubled loans with practical advice and strategy. The paradigm for most of the discussion is a first mortgage loan on a cash-flowing office building but other property types, loan structures and the issues specific to them will be addressed as well.³ The objective of this guide is not to provide solutions to particular distressed situations. Workouts are far too fact specific for any "one size fits all" solution. Rather, the objective of this guide is to provide lenders with an approach to analyze distressed loans and tailor solutions to fit the particular situation.

Prior to the financial crisis, housing market meltdown and general decline in commercial real estate markets that began in the Summer of 2008, one would have to go back to the early 1990s to identify the last prolonged "down market" in commercial real estate. While Lenders may have had individual projects or loans that have performed poorly since then, even most veteran bankers have not experienced a market in which macroeconomic conditions have caused an erosion in real estate values of the magnitude we are now experiencing as a result of both declines in property cash flows and increases in market capitalization rates. We have also seen a virtual shut down in the origination of new commercial loans and a collapse of the investment sales market with wide spread loan defaults resulting or anticipated. Many lenders have not really begun to resolve their troubled loans and there are billions of dollars of commercial real estate loans that are maturing in the next few years but cannot be refinanced in amounts sufficient to repay the outstanding debt. It is still relatively early in this down cycle and much uncertainty remains. However, it is already becoming clear that there will be unique issues raised in this cycle due to the severity of the global recession and the highly structured nature of real estate finance. It is equally clear that many of the lessons learned in previous down cycles will apply to this cycle as well.

³ References made to "**property**" refer to the real property and improvements that directly or indirectly secure the repayment of the applicable loan.

A number of themes will emerge in the discussion that follows. First, Lenders must freshly underwrite a loan and its underlying collateral when the loan goes into distress. Markets have certainly fallen but a lender must move beyond general conditions and develop a detailed view of the particular issues facing a property, the borrower and sponsorship. Second, Lenders must understand and realistically assess the time, costs and risks associated with an exercise of remedies by the Lender against its collateral. After all, exercise of remedies is what will eventually occur if no deal is made with the Borrower so it forms the base line against which all restructuring or workout proposals should be evaluated. Lenders do have to be prepared to proceed against their collateral and must credibly establish with Borrowers that they are willing to do so. However, they must also understand the risks, costs and difficulties in doing so. Finally, in most workouts each of the following statements is usually true:

- » the Lender would be better off taking the Borrower's best offer than it would be exercising remedies and proceeding against its collateral
- » the Borrower would be better off taking the Lender's best offer than it would fighting an exercise of remedies in court or in bankruptcy

Who gets the better deal between Borrower's best offer and Lender's best offer comes down, in simpler cases, to negotiating skill. Of course, the presence of multiple players, whether as subordinated lenders or members of syndicates, with divergent interests and agendas, can thwart or impede otherwise sensible resolutions.

II. THRESHOLD QUESTIONS

The first step in the development of a workout strategy by any Lender must be a careful analysis of the status of the loan and the underlying real property collateral. When a loan enters the workout phase, the facts that existed at closing become largely irrelevant. Instead, the Lender must take a hard and fresh look at where the loan and the underlying property is at that time. As a starting point, a Lender should answer the following threshold questions:

- » What is the nature of the current or anticipated problems with the loan?
- » Is foreclosure or other exercise of remedies an option?
- » What is the value of the property and is there value in the Lender's position?
- » What cash flow is/will be produced by the collateral property?
- » Does the Lender have adequate control over property cash flow?
- » Can the performance/value of the property be improved with time or otherwise?

- » Does the property require additional capital?
- » Is continued control by the current Borrower/sponsor group a positive or negative factor?
- » Are there structural impediments to a workout?

A. What is the Nature of the Current or Anticipated Problems with the Loan?

1. Defaults/Events of Default

The most common reason for a loan to go into “workout” is the occurrence of a **default** under the loan. The most obvious default would be a failure to make a required payment of interest or principal or to pay some other amount required under the loan documents (a **monetary default**). The Borrower could also have defaulted in the performance of other covenants and obligations not involving the payment of money (a **non-monetary default**). Generally, loan documents provide Borrowers with notice and some period (a **cure period**)⁴ to remedy defaults before the default ripens into an **Event of Default**, which would entitle the Lender to declare the full amount of the loan due and payable (**acceleration**) and to exercise remedies against the Borrower. It is sometimes difficult to ascertain when a non-monetary default becomes an Event of Default because loan documents often provide that a cure period for a non-monetary default can be extended so long as the Borrower is diligently and continuously endeavoring to remedy the default. In construction financing, there are additional potential defaults. For example, the construction might not be completed by a required completion deadline. Also, cost overruns can cause a loan to become **out of balance** (that is, the funds remaining to be advanced under the construction loan are not sufficient to complete the construction), which can become a default if the Borrower fails to contribute additional equity to bring the loan back into balance.

2. Financial or Performance Defaults

A loan may be performing (*i.e.*, debt service is being paid currently) and still be in default because of a breach of performance or financial covenants such as failure to achieve minimum debt service coverage ratios⁵, minimum debt yields⁶ or the

4 Generally, loan documents do not require the Lender to provide Borrowers with notice of default in the case of a regular interest payment and do not provide a cure period for a default arising from the failure by Borrower to repay the loan at its maturity.

5 Debt service coverage ratio or DSCR is the ratio over a 12 month or quarterly period of the net cash flow of the property (before debt service) to the scheduled debt service under the loan for the same period.

6 Debt yield is the percentage obtained by dividing the net cash flow from the property (before debt service) by the principal amount of the loan.

occurrence of material adverse change. Lenders seek to include these types of covenants in loan documents because they provide a type of early warning system when a problem at a property – such as declining occupancy at a hotel – arises but does not immediately result in the Borrower’s inability to pay debt service. In many cases, loan documents will provide that these types of defaults trigger more onerous restrictions on the Borrower such as a sweep of excess cash, Lender approval of property budgets or a restriction on distributions by the Borrower. By creating a default, the objective of these covenants is often to force the Borrower to the table to either restructure the loan or otherwise address the underlying problem.

Exercising remedies, such as foreclosure, based on a default on a financial or performance covenant is substantially more difficult than is the case with a monetary default. The covenant must be clearly and objectively drafted (a formula rather than something along the lines of a “material decline in net income”). The Lender should also be able to show clear connection between the financial covenant, the security of the loan and the Borrower’s ability to perform. For example, it would be difficult to foreclose a loan based on a default under a net worth covenant of a Sponsor if that Sponsor was not a guarantor of or otherwise an obligor on all or some portion of the loan.

3. Other Reasons for Workouts

While most loans do not go into “workout” unless they are in default, that is not always the case. A Borrower may proactively seek restructuring of a loan (usually meaning relief from its obligations in some manner) because it is aware of circumstances that will put the loan into distress in the future. These circumstances could include:

- » bankruptcy of or default by a key tenant;
- » decisions by one or more tenants not to renew their leases;
- » a capital repair need that neither the Property nor the Borrower have cash to fund;
- » slow sales of condo units making full repayment by maturity unlikely.

Perhaps the most common rationale in today’s market for a workout of a loan that is not in default is that reduction in property values and tightening of credit standards will make it impossible to refinance the entire amount of the loan at maturity.

Restructuring a loan before it goes into a default has both positive and negative implications for a Lender. Implementing a restructuring before a default can avoid the loan becoming “non-performing” and the regulatory and capital implications of that status, particularly for bank Lenders. Lenders would also generally prefer that their Borrowers

be proactive and address problems at properties as they arise rather than waiting for a default. On the negative side, the fact that the loan is not yet in default means that the Lender does not have the option of calling the loan and exercising remedies against the collateral. Borrowers are often more aggressive with their restructuring proposals at this stage because foreclosure is not a current risk. As discussed below,⁷ some Borrowers are encountering difficulty in proactively pursuing restructurings of securitized loans that are not currently in default because master Servicers are ill equipped for restructurings and Special Servicers do not engage prior to default.

Whether the loan is technically in default or not, the Lender must understand the underlying causes for the loan being in distress. In the current market, virtually every property has lost value. Hotels are facing reduced occupancy and a sharp decline in conference and convention business. Residential rents are down and the condominium sales market has virtually evaporated in many locations. Retailers are feeling the pain of reduced consumer spending and failures of both “anchors” and “line stores” are adversely affecting malls and shopping centers. However, while one or more of these factors may affect the property securing a loan, this should not be the end of the Lender’s inquiry. Instead, the Lender must determine how the general market conditions combine with the specific attributes of a given property in order to assess the true status of the collateral and loan. For example, consider two loans that are secured by different office buildings in the same market that have each lost tenants due to bankruptcy. If one building is newer and more technologically advanced than the other or one is better located or better managed than the other, the two buildings face different prospects for procuring a replacement tenant and the feasibility of working out each of the loans based upon an extension to allow re-tenanting could be quite different.

B. Is Foreclosure or Other Exercise of Remedies an Option?

1. Materiality

Courts in virtually every jurisdiction have consistently held that a Lender cannot accelerate a loan or foreclose a mortgage unless the underlying default is “material”. Lenders, of course, want to know what material means in the context of a loan default and what types of defaults are sufficiently serious to allow a Lender to accelerate and foreclose. Unfortunately, the answer is not always clear. While there are few reported cases this early in the present cycle, what does seem to be a trend based on anecdotal evidence is that Borrowers are being increasingly aggressive in trying to expand the boundaries of what courts will see as immaterial and that courts seem receptive to creative arguments on materiality.

7 See Section IX *infra*.

The simplest case is that of a loan that is not repaid at its maturity. Lenders do not have any legal obligation to extend the maturity of loans (beyond the extension options expressly set forth in loan documents) and there is no doubt that a maturity default is “material”. However, Borrowers are attacking even this clearest of defaults in transactions in which the loan documents provided an ability for the Borrower to extend the term of the loan but the Borrower did not satisfy the conditions to such extension. Borrowers facing potential foreclosure have brought litigation seeking to enjoin exercise of remedies on the basis that the failed conditions were not material and the extension should have been granted. In one case pending as of this printing, the Borrower has gone as far as to argue that a condition to extension that the property achieve a minimum debt service coverage ratio was immaterial and should be ignored by the court.⁸

A monetary default arising from a failure of the Borrower to pay principal or interest is also relatively straight forward. With the possible exception of **default rate interest**⁹ (or other payment obligations that the courts may view as an unreasonable penalty), courts have not created significant doubts as to the ability of a Lender to exercise its remedies based on Borrower’s failure to pay required payments of principal or interest after the expiration of the applicable cure period.

On the other end of the spectrum, few practitioners would advise their client that the failure of a Borrower to provide periodic financial statements or other required reports is sufficiently material to permit acceleration or foreclosure. Similarly, a minor breach of other non-monetary covenants that do not directly impact the value of the collateral or the validity and priority of the Lender’s lien do not likely pass muster either.

What’s left between these two ends of the spectrum in a vast number of potential defaults with respect to which the Lender’s right to foreclose is somewhat less clear. Each such default must be analyzed on a case-by-case basis in the context of a specific loan and the impact of the particular default on the applicable real property collateral and the ability of the Borrower to perform its obligations under the loan documents. Generally though, it appears that courts throughout the country are showing a greater inclination in this downturn to at least listen to Borrowers’ often creative justifications

8 Another tactic that Borrowers will often utilize in a foreclosure action following the maturity of a loan is to claim that certain actions of the Lender constituted an agreement to extend the loan.

9 Loan documents typically provide that the interest rate payable by a Borrower automatically increases after the occurrence of an Event of Default.

as to why a foreclosure should be prohibited despite a default on the applicable loan.¹⁰

2. Force Majeure

Lenders may also face difficulty in exercising remedies after an Event of Default if the Borrower can establish that the default was the result of causes beyond its reasonable control. Many loan documents include clauses which provide that the Borrower is excused from the requirement to perform certain obligations if it is prevented from doing so by reason of **force majeure**. The definition of “force majeure” typically includes war, civil unrest, terrorist attack, acts of God, materials shortages or labor unrest. The exact definition and the operation of these clauses (for example, does the Borrower have to notify Lender of the force majeure event when it happens in order to claim excuse for performance later) is often highly negotiated and must be evaluated in each transaction. In most cases, however, force majeure does not apply to monetary obligations and the list of causes that excuse Borrower’s performance does not include lack of sufficient funds. In some recent cases, Borrowers (most notably Donald Trump on a condo loan in Chicago) have brought litigation against Lenders in an attempt to expand the concept of force majeure to encompass an inability to obtain financing to repay a loan because of the general unavailability of financing in the current market. To date, no court has adopted this concept and those courts that have addressed this argument have rejected it.¹¹

Even if the applicable loan documents do not contain a force majeure clause, a Lender may still have a hard time seeking a foreclosure based on a non-monetary default if the Borrower did not cause it and either cannot fix it or is doing everything it can to fix it but has not completed the remedy. Foreclosure wipes out the Borrower’s interest entirely and courts view it as a relatively drastic remedy. This does not mean that one cannot effectively craft a non-monetary default based on some event that is material to the transaction whether or not the occurrence or non-occurrence of such event can be controlled by the Borrower. Rather, it means that default provisions for non-monetary obligations must be thought through and carefully crafted and that Lenders should understand the limitations that they may face in seeking to exercise remedies based non-monetary defaults.

10 Judging from language included in various reported decisions, this inclination may arise from a combination of concern about the sheer number of foreclosures potentially facing the courts and a commonly held view that real estate lenders are partly to blame for this situation in which they now find themselves.

11 In fact, Katten attorneys were able to obtain a summary judgment rejecting this argument in a recent high profile case in New York.

3. Material Adverse Change/Post-Closing Obligations

Certain non-monetary defaults are particularly troublesome as a basis for exercise of remedies. The best example is a default based on a **material adverse change** or **MAC**. Some loan documents provide that it is an Event of Default if there occurs a material adverse change affecting the Borrower or the property. Obviously, these MAC defaults can be triggered by any number of events that are beyond the Borrower's control. Moreover, they are often quite vague¹² and courts can either construe them narrowly to the benefit of the Borrower or conclude that there was no real meeting of the minds on the MAC clause and simply not enforce it. For different reasons, it is also very difficult to exercise remedies based on a Borrower's failure to perform post-closing obligations. Over the last 5-10 years it became increasingly common for Lenders to close loans notwithstanding the fact that certain closing conditions had not been satisfied. In these cases, the Lender would require that the Borrower enter into a **post-closing letter** requiring that the Borrower perform the necessary tasks to satisfy the unsatisfied conditions by a given deadline. Typically, these post-closing letters would provide that the failure of the Borrower to perform the stated tasks by the date provided would constitute an Event of Default. The problem with this approach, however, arises because in order to exercise remedies after the Borrower defaults in the performance of its obligations under a post-closing letter, the Lender must argue that the default is material. Query how the Lender can succeed in that argument when the Lender was willing to fund the loan at closing when the obligation had yet to be performed?

There have been a number of cases addressing MAC clauses tied to (i) changes shown in periodic financial statements, (ii) a MAC in Borrower's "ability to perform its obligations under the loan documents" and (iii) a MAC in the "prospects" for the property. Courts have consistently looked for clear, provable changes in circumstances that are material to the loan. Given the severity of foreclosure as a remedy, we expect that the courts will continue to require exacting standards of proof by Lenders seeking to declare an Event of Default for a breach of a MAC provisions.

If Lenders could take away one central concept in assessing their ability to exercise a remedy based on a default under their loan documents, that concept should be that Lenders and Borrowers do not operate on a level playing field when a Lender goes to court to enforce its rights against a defaulting Borrower. A foreclosure results in a complete forfeiture of a Borrower's interest in an asset (real estate) that the law has long viewed as unique. Foreclosure is viewed by courts as a rather drastic remedy and there is often stated or unstated reluctance in the courts to grant that remedy where the

12 A common formulation is "a material adverse change in the properties, condition (financial or otherwise) or prospects of the Borrower or Property."

existence or materiality of the default is in dispute.¹³ This reality does not necessarily mean that a Lender will not be able to obtain control of its real property collateral. Frequently though, it means that it may take more time and cost more to do so than a Lender initially anticipates.

4. Termination of Funding Commitments

Similar issues arise in determining whether a default under a loan agreement is sufficiently material to allow a Lender to terminate a future funding commitment. In the current down cycle, many Lenders have found themselves committed to fund transactions that they would not do today. Like an exercise of remedies, whether defaults or other failures of condition justify a refusal to fund is again a case-by-case determination. The stakes, however, may be quite a bit higher. If a Lender brings a foreclosure action and a court determines that the underlying default is not sufficiently material, the result will be that the loan gets reinstated and the Lender could be assessed costs. In contrast, if a Lender refuses to fund a loan and a court subsequently holds that there was not sufficient basis to do so, the Lender could be held liable for the damages suffered by the Borrower resulting from such refusal – damages that can be quite substantial. In the case of a syndicated loan, the non-funding Lender could have liability to the other Lenders and agent bank as well.

C. **What is the Value of the Property?**

1. Obtaining an Appraisal

In order to effectively evaluate its options with respect to a workout or foreclosure, a Lender must formulate a view as to the current value of the property. That process usually begins with the Lender commissioning a new appraisal. Loan documents typically give the Lender the right to obtain a new appraisal at the Borrower's expense either periodically (such as once a year) or at least after the occurrence of an Event of Default. Of course, having loan documents that obligate the Borrower to pay for the appraisal does not mean that the Borrower will actually write the check – the failure or inability of Borrower to meet its obligations may be the reason the appraisal is being ordered in the first place.

- » **Workout Tip:** Workout appraisals should be commissioned by the Lenders outside counsel, not the Lender itself. By doing so, the appraisal is subject to the attorney-client privilege. Otherwise, the appraisal could be subject to discovery by the Borrower in a subsequent litigation or bankruptcy.

¹³ Although there has been no comprehensive study as yet, anecdotal evidence from cases coming before courts in the early part of this cycle suggests that there may be an even greater tendency in the courts in this cycle to find a reason to avoid foreclosure.

When ordering a new appraisal careful consideration should be given to the instructions to be given to the appraiser. The appraiser can be requested to consider multiple valuation scenarios. For example, a condominium project can be appraised on a “sell-out” basis and as a rental apartment building. A hotel project can be appraised on the assumption that the existing manager is retained and assuming the current management agreement is terminated. A condo hotel can be appraised as a condo hotel or on the assumption that it is converted to a traditional hotel use. Multi-phase construction projects can be appraised with various assumptions as to which phases are completed and which are not. A project can be appraised “as is” or at its **stabilized value**.

2. Beyond the Appraisal

A Lender’s valuation of its collateral should not end with the appraisal. This is particularly true in the current market. Appraisers typically utilize three methods to determine value: (1) comparative sales, (2) replacement cost and (3) capitalized cash flow. In the current market, there are few if any comparative sales for an appraiser to use as guidance. Replacement cost is largely irrelevant as the decline in the real estate market has resulted in the vast majority of properties being worth less than replacement cost. Capitalization of net cash flow has become little more than guess work because of the uncertainty surrounding future cash flow assumptions and the lack of anything approaching a market consensus on capitalization rates.

As a result, Lenders need to dig more deeply into the collateral securing their loans, make their own assumptions about current and future revenues and expenses and make an educated guess as to an appropriate capitalization rate. They must also determine whether and to what extent value will be adversely affected by a foreclosure versus reaching an agreement with the Borrower to market and sell the property for the best price it can obtain.¹⁴ For example, properties that are dependent on management services, such as hotels and retail malls may be more negatively affected by a foreclosure than would an office building.

In essence, the Lender must re-underwrite the assets as if it were initially making the loan. In reality, Lenders should be doing this type of analysis in every workout scenario, but in a better sales market, there tends to be more reliance on appraisals. In some cases, Lenders should consider retaining a more specialized financial consultant to assist in the valuation process. Property types like senior living and resorts are as much operating businesses as real property and it can be helpful to have a consultant familiar with that particular business to supplement the work done by the appraiser.

14 Of course, in today’s world it is very difficult to keep people from becoming aware that a property is being marketed because of an agreement with the Lender.

D. What Cash Flow is/will be Produced by the Property?

Workout strategy is also directly impacted by the status of cash flow from the property. The current market continues to be characterized by historically low interest rates. As a result, there are many office, retail and multi-family properties that produce sufficient net cash flow after payment of operating expenses to service the debt in place but are workouts nonetheless because the rise in capitalization rates and tightening of underwriting standards will make them impossible to refinance in an amount sufficient to retire the existing debt. These types of loans have been the first to be restructured by Lenders, largely through negotiated loan extensions. Even servicers and special servicers have been comfortable extending loan maturities in these situations so long as no other loan modifications are required. The question for Lenders (which will be addressed below) is what other benefits or considerations can they negotiate in return for extending the maturity.

Compare the foregoing scenario to a condominium construction financing in a location in which the condominium sales market has collapsed. This type of project does not produce any cash flow unless the project can be converted to a rental or unsold units can be rented. Even if rental is possible, the high values at which condominium projects were underwritten in the boom market (and the declines in residential rents) usually means that rental income will not be sufficient to service the debt after payment of insurance premiums, real estate taxes and other operating expenses (whether paid directly or in the form of **common charges**). Extending a loan on a property that produces a negative cash flow would not make sense unless either (a) the Lender was willing to forego debt service and fund operating expenses or (b) the **sponsor** is willing and able to fund the debt service and operating expenses during the extension term.

These two scenarios are quite different but each is relatively straightforward. It gets more complicated when there is existing but uncertain cash flow. Examples in the current market include (i) a hotel with substantially decreased occupancy and conference business, (ii) an office building with expiring leases and (iii) a mall in which one or more of the key tenants has filed for bankruptcy or is otherwise in distress. In these situations, the Lender must develop a view as to the difference between the cash flow that will be produced by the property over the remaining term of the loan and the cash needs for the property over the same period. This exercise requires an in depth look at the property and a strong command of real estate fundamentals. General assumptions as to what percentage of tenants renew and general assumptions of annual capital expenditures per square foot are not sufficient. The Lender will need to assess each tenant (and any vacant space) and make judgments as to its business prospects and continued viability as well as the likelihood that renewal, expansion or termination

options will be exercised. In many cases, a consulting engineer should be retained to conduct a physical inspection in order to assess the need for future capital expenditures and whether maintenance and repairs have been deferred. If there is positive cash flow but less than a 1.0:1.0 debt service coverage ratio, it can only be covered by an injection of additional equity or forbearance (or accrual) by the Lender.

Anticipating cash flows for properties with current or near term vacancies has been further complicated by the recent declines in rents. Loan documents have historically been structured on the assumption that the Borrower is motivated to lease the property. Lenders are reactive, either approving or disapproving leases proposed by the Borrower. In the current downturn, however, rents have dropped significantly in virtually all markets and across virtually all property types. With these drops in rents, many Borrowers face the unpleasant reality that leasing the space that they have vacant or that is coming vacant in the near term at current market rents will effectively eliminate any argument that they have any remaining equity in the property. Borrowers in this situation will want to delay re-leasing space as long as they can in the hopes that rents will go up and will try to buy as much time as they can with the Lender. Lenders considering extension requests from Borrowers should keep these incentives in mind because there is simply no practical way to go to court and force a Borrower to sign a lease. Even if one could objectively define the terms of a lease that the loan documents would require Borrower to sign, Borrower's failure to do so would simply be a default that would require the Lender to then foreclose. Leases are simply too complicated to expect any court to grant specific performance and order a Borrower to sign one. As a result, Lenders should try to create positive incentives to leasing when structuring workouts of properties with anticipated vacancies in the current market.¹⁵ If sufficient positive incentives cannot be created, the Lender must give a second thought to whether a workout with the existing sponsorship is, in fact, feasible.

And if things were not already sufficiently complicated, the existence of multiple tranches of Lenders with different priorities can further exacerbate cash flow issues. It is common in multi-tranche financings for the mortgage lender and multiple levels of mezzanine lenders to each have approval rights over leases. Even with a cooperative Borrower, mezzanine lenders may not be willing to approve leases at rents that will protect the position of the mortgage loan but leave the mezzanine loan impaired. This conflict underscores the importance for the Lender to develop its own view of the present value of the underlying property collateral. If, for example, the senior lender valued the property at a level that wipes out a mezzanine level, the senior lender would

15 A lender could consider, for example, a cash payment to the Borrower for successful leasing (akin to a commission) or perhaps a credit against the eventual repayment tied to the enhancement in value created by the lease.

probably not want that mezzanine lender to have lease approval rights after the closing of any restructuring as it would likely use those rights to reject any lease that would effectively hard wire the mezzanine lender's loss.

E. Does the Lender have Adequate Control over Property Cash Flow?

1. Assignments of Rents and Lockboxes

If a loan is secured by property that does produce cash flow, the Lender's initial review should include a determination as to whether the Lender has adequate control over the collection and use of that cash flow. In the real estate downturn of the late 1980s early 1990s, control of property cash flow became a major issue and a frequent source of leverage for Borrowers. Loan documents would universally include (either as a provision in the mortgage or as a separate instrument) an assignment of all of the Borrower's rights in the **rents**¹⁶ from the property (an **assignment of rents**). The assignment would usually be drafted as an absolute present assignment of the rents (as opposed to the grant of a security interest) from the Borrower to the Lender and provide a license back to the Borrower to receive and collect the rents that would immediately terminate upon the occurrence of an Event of Default. Lenders (and to a large extent their counsel) assumed that these assignments worked as they were written.¹⁷ The reality, however, was (and is) that an assignment of rents (no matter how absolutely drafted) does not entitle the Lender to actually receive and retain the cash until either (i) a foreclosure is completed, (ii) a receiver is appointed over the property in connection with a foreclosure or (iii) the Borrower agrees to turn the rents over. There were even some cases in the early portion of that cycle that held that a Lender did not have a "**perfected**" security interest in the rents until one of the events described in (i) through (iii) above occurred and, as a result, a bankruptcy filing by the Borrower prior to any such event occurring could mean that the assignment of rents could be voided in the bankruptcy.¹⁸ The uncertainty created by these early cases and the potential expense and delays faced by Lenders in getting receivers appointed in foreclosure actions led to increased use of cash management or "**lockbox**" arrangements in loan documents for loans on cash flowing properties.

16 "Rents" was generally defined very broadly to pick up all revenue produced from the property.

17 This approach originally arose from the overly creative notion that if an assignment of rents was drafted as a separate instrument and as an absolute present assignment, Lenders might be able to get control over cash flow prior to conclusion of what can in many jurisdictions be a lengthy foreclosure process.

18 The powers of a debtor-in-possession or bankruptcy trustee to avoid certain security interests and other transfers is discussed in Section VI.

2. Types of Lockbox or Cash Management Arrangements

It is now more the rule than the exception that loans on cash flowing real estate include a cash management agreement or “lockbox”. Unfortunately, “cash management” and “lockbox” have become relatively generic terms that refer to a fairly wide variety of arrangements that provide Lenders with more or less control over cash. The Lender’s threshold review in a proposed workout should include careful inquiry by Lender’s counsel into the exact terms of the current cash management system as a workout or restructuring of a distressed loan may present the Lender with an opportunity to firm up its control over property cash flow.

Under a true “lockbox”, tenants pay their rents directly into an account that has been pledged to the Lender as security for the loan and from which only the Lender can withdraw funds. Actual arrangements can vary from this paradigm in a number of ways. In hotel properties, room and other revenues (which are often paid by credit card) are collected by the hotel manager. Often, the management agreement provides for the property operating accounts to be held by the manager so it can pay operating expenses (and, of course, its fees). Under this type of arrangement, the Lender would not have a perfected security interest in the manager’s accounts and could face difficulties in getting control over the cash following a Borrower or manager bankruptcy. However, a manager will often recognize the security interest of the Lender and agree to hold funds “in trust”. The price for this is that even after an Event of Default, the Lender must make operating expenses (including the management fee) available to the manager. Owners of apartment complexes may also resist true lockbox arrangements because they are administratively burdensome when tenants often drop off rent checks (or even cash) at the property management office. Other loans close without lockbox arrangements in place with loan documents that obligate the Borrower to establish a cash management system either upon a default or the failure of the property to meet some performance threshold.

A lockbox account is called a lockbox account because, at least in theory, the Borrower can not withdraw funds from the account. In fact, under the law of most jurisdictions a Lender’s security interest in a **deposit account** can only be perfected through the Lender having **dominion and control** over the account. Dominion and control is established through an **account control agreement** among the Borrower, Lender and **Deposit Bank**, which agreement provides for the establishment of the account or accounts, acknowledges the Lender’s security interest in the account(s) and provides that only the Lender has the right to withdraw funds from the account(s).

In practice, cash management systems also vary significantly in how the Borrower can get money from the lockbox. Frequently, the account control agreement will provide

that funds are swept daily and automatically from the lockbox account into an unrestricted account of the Borrower (its checking account) unless and until the Lender notifies the Deposit Bank to cease such transfers. Loan documents generally give the Lender the right to send such a notice upon an Event of Default or some earlier trigger such as failure to maintain a minimum DSCR. In other transactions, funds collected into the lockbox are first applied to fund agreed upon reserves then the balance is transferred into the Borrower's account. In the strictest of cash management systems, the Borrower must make draw requests monthly to obtain funds from the lockbox to pay property operating expenses.

3. Tightening the Lockbox

If a loan is being restructured in a distress scenario, Lenders are often well advised to tighten their controls over the cash. In hotel transactions, a new arrangement may need to be negotiated with the manager to move the main collection account out of the manager's hands. It will be rare that the Lender will want approval over each month's expenses but it may be advisable to only allow disbursements in accordance with an established waterfall and an operating budget approved by the Lender. Scrutiny must also be given at the time of a workout to affiliate management relationships and other "operating expenses" that are paid to affiliates of the Borrower as these can be more about the Borrower taking money out of the property than legitimate operating expenses. It is not uncommon, for example, for an affiliate of the Borrower to be retained as property manager and subcontract all of its duties to a third party for a fee that is less than the fee payable to the affiliate manager.

4. Distribution Blocks

Ultimately, the objective of lockbox or cash management arrangements is to prevent cash generated by a property from leaking out to the owners or affiliates of the Borrower. In non-recourse loans, Lenders generally have no ability to recover funds distributed by a Borrower to its equity owners once the distribution has been made.¹⁹ Lenders can also address this issue by including covenants in loan documents that prohibit distributions to owners of the Borrower (and often payments to affiliates of the Borrower that are otherwise characterized as expenses) until the Loan is repaid. If the property is producing net cash flow after debt service, that cash flow would simply build up at the Borrower level. Borrower could, of course, simply breach this obligation as it breaches its obligation to repay the loan and undoubtedly other obligations

¹⁹ Some so-called "recourse carve-out guaranties" do make the guarantor liable for distributions made after an Event of Default. Also, some jurisdictions, such as Delaware, prohibit limited liability companies from making distributions when it is insolvent and permit claw-back of distributions made in violation of such prohibition.

under the loan documents as well. However, breach of a dividend restriction does more than create another default under the loan documents. It could, either directly or through recourse liability for intentional misconduct, create a right to recover amounts wrongfully distributed.

F. Can the Performance/Value of the Property be Improved with Time or Otherwise?

The flip side of a Lender's determination of the current value of the property serving as collateral for its loan is whether the performance or value of the property can be improved. This question as much as any other, affects the Lender's options in a distressed scenario. If a Lender finds itself with a loan for which the property cannot cover the debt service or there is inadequate value to refinance and the Lender concludes that the situation will not likely improve within any relevant time period, the options available to the Lender are quite limited. The Lender could either write down the principal of the loan to a level that the property could service (and hopefully refinance) and keep the current Borrower in place or it could foreclose and sell the property for the best price available. If the Borrower has a more optimistic view of the property, the lender may be able to get something out of the Borrower in consideration of the write down (such as a pay down or posting interests reserves). If the Borrower did not see any up side in the property, the Lender would likely have to give something (such as a management fee) for the Borrower to keep working the property. In such a case, foreclosure and liquidation is generally the preferable approach.

If the Lender determines that property performance or value can be improved, it must then make a judgment as to what and how long it will take to realize such improvement. Most Borrowers in the current market take the position that all they need is time to let the market come back (whether its the condo, office, retail or hotel market) and everything will be fine. In many cases this may well be true but it does not answer the critical question – how long? While no one can predict with any certainty when any particular market will rebound, what Lenders can do is make sure that restructurings are logically consistent. If a Borrower on a completed but largely unsold condominium project is projecting a new sales schedule that takes an additional two years, a two-year extension does not make a great deal of sense unless either the sponsor is funding reserves to cover the costs for those two years or the Lender has concluded that its recovery will be greater with the longer sales period even assuming that it will be funding operating costs and accruing interest over the two year extension period. Otherwise, the Lender will simply be facing a new default scenario prior to the end of the two-year period. Of course, in some cases a Lender may take a calculated gamble that if a Borrower is willing to commit a fixed amount of additional capital in exchange for an extension then even if that additional capital is not enough to cover all needs of the

property through the extended maturity, the Borrower will again act to close the gap and protect its position.

In other cases, property improvement may require more than time alone. There may be incomplete improvements, required capital refurbishments or re-tenanting issues. In other cases, there may be deficiencies in management that need to be addressed. Expenses may be out of line with industry standards for similar properties or the sales and marketing efforts may be lacking. In some respects, these types of issues can be good news for a Lender because it means that there may be actions that can be taken currently to improve property value and there are options other than simply waiting for the market to turn. On the other hand, many of these actions to improve property performance could require capital which Borrowers frequently do not have and Lenders are hesitant to fund into an already distressed situation. In any event, the Lender needs to understand what actions are required with respect to the property and then structure the workout so that these actions are taken and funded.

G. Does the Property Require Additional Capital?

Perhaps the most difficult workouts are those where the underlying property has need for substantial additional capital. In some respects, all distressed property situations are situations that require additional capital since they can neither be refinanced nor sold for an amount sufficient to pay off the existing property debt. For purposes of this discussion, however, we exclude requirements for additional capital to repay the principal amount of the loan. Instead, this section focuses on loans for which additional capital is required to either complete the improvements on the property or to operate and maintain the property through the actual or proposed maturity of the loan.

Workouts of these types of loans are difficult because there is frequently no one in a position to provide the additional capital. Single purpose Borrowers, by definition, have no additional capital if the property is in distress, as it represents their only asset. Sponsors may also be unable or unwilling to contribute the necessary capital.²⁰ If a Sponsor is willing to contribute additional capital it may seek a preferential treatment for that capital. If for example, the property is currently worth less than the debt the Borrower's equity is worth nothing and no rational Borrower would contribute additional capital unless it anticipated a reasonable opportunity for a return on that capital. Viscerally, a Lender may have a strong negative reaction to any departure from the general paradigm that no money goes to equity until the debt is paid. Objectively, however, if the additional capital contributed would lead to a greater recovery by the

20 Real estate funds, in particular may not have the ability to call additional capital for existing investments if the fund is past its investment period or is fully invested.

Lender, the Lender should consider giving the new money some benefit. Treatments could include:

- » Splitting cash flow and capital proceeds between the debt and new money by fixed or variable percentages;
- » Creating a waterfall whereby a portion of the debt is repaid, then the new capital plus return then the remainder of the debt; or
- » Giving the new capital priority over the debt.

The arguments in favor of providing an incentive to new capital can become compelling in cases in which the new capital creates substantial new value. In construction projects, if the new capital allows the project to be completed the marginal impact on value can greatly exceed the amount of the new capital.²¹ Similarly, if the new capital is needed to fund the cost of re-tenanting a building, the increased value may be well worth the preference given to the new equity.

On the other hand, Lenders in the current market may be in less of a position to contribute additional capital to distressed projects than Borrowers. Although there are more than a few lenders whose financial conditions are precarious, for the most part the difficulties Lenders face in providing additional capital to distressed loan properties is more about willingness to fund than ability to fund. It is extraordinarily difficult these days for any Lender to obtain the necessary credit approvals to advance additional funds into a workout. There is no guaranty of success even where the business case that the new funds will increase the ultimate recovery is strong. Funding new capital is particularly difficult for those Lenders that are exiting the market once they have worked through their portfolios. In syndicated loans, the issue gets even more complicated as new advances require that either all of the Lenders agree to fund their respective shares or some of the Lenders fund and all of the Lenders agree as to how those additional advances will be treated *vis-a-vis* the rest of the loan. In securitized loans, it is basically impossible to get the Lender to fund more money since there is no “lender” in the classic sense of the word. It is simply not feasible to go to the bondholders of the pool to try to get them to fund additional money with respect to a particular loan.

H. Is Continued Control by the Current Borrower/Sponsor Group a Positive or Negative Factor?

The ultimate threshold question for a Lender facing a potential workout/restructuring

21 That is the value of a completed project is likely to exceed that of an unfinished project by an amount that is greater than the cost to complete, given the additional risks that a buyer of an unfinished project must take on.

scenario is whether it makes sense to keep the property under the control of the current Borrower/Sponsor. A Borrowers/Sponsor can essentially bring two potential assets to the table in a workout scenario – expertise and capital. As to expertise, a Lender must ask itself whether the current Borrower/Sponsor possesses the skill set to achieve the best performance and value for the property. There are many projects that are in distress in the current market and are owned by highly competent sponsorship that has simply been caught in the market downturn. However, the easy access to capital that characterized the market of recent years also resulted in a large amount of real estate being owned by new entities and funds with less experience and little or no infrastructure or expertise to turn properties around. For example, the developer of a condominium project may have little or no expertise in running a rental project when economics dictate that conversion to rental is probably the best approach. Other Borrowers may have been acceptable operators in a booming market but lack the skills and experience to maximize project value in an environment in which competition for tenants or purchasers is fierce and the need to realize operating efficiencies is critical. Of course, a Lender may be able to overlook a lack of experience in the sponsorship if the sponsorship is willing and able to commit the additional capital that the workout may require. Unfortunately, many of these same entities that were relatively new to the market also came in with fixed sources of capital (*i.e.*, funds) and cannot go back to their investors for additional funds. If the current sponsorship does not bring a definitive skill set to the table and cannot put in any additional capital, the Lender must seriously consider whether it makes sense to do a workout or proceed with remedies.

I. Are there Structural Impediments to a Workout?

Throughout their analysis, Lenders must consider whether there are structural impediments or issues that will impact the ability to do a workout. In the current cycle, characterized by multi-tranched and fragmented financing structures, that usually means that the Lender must familiarize itself with who must be at the table to successfully conclude a workout. For example, **mezzanine loans** are typically cross defaulted to mortgage loans on the applicable project. Outside of default, **intercreditor agreements** typically restrict the ability of the mortgage lender to make certain amendments. Consequently, if there is mezzanine financing on a project, the mortgage lender cannot conclude a workout with the Borrower unless the mezzanine loan is also dealt with. Similarly, in a **syndicated loan**, the agent bank must familiarize itself with the consent requirements in the loan agreement or co-lender agreement (that is, which amendments can an agent make unilaterally, which require majority or two thirds consent of the lenders and which require unanimous consent) so it can understand the degree of participation that will be required of the lending syndicate. In A/B or similar multi-tranched mortgage loans, the **controlling holder** must review the applicable

co-lender agreement to determine its limits in negotiating a restructuring. If the “**A**” piece has been securitized, the controlling holder may be subject to having to obtain approval of a **servicer** or **special servicer** for any restructuring proposal.²²

III. KICKING THE TIRES — INITIAL DUE DILIGENCE

In order to answer threshold questions and critically evaluate its workout position, a Lender must start the workout process with a thorough due diligence investigation of the loan. This may seem somewhat counter-intuitive. After all, if the Lender originated the distressed loan, it presumably did due diligence prior to closing. In fact, workout diligence is a different process for a different purpose. Essentially, the Lender needs to understand fully its factual and legal position, both strengths and weaknesses in order to formulate the most effective strategy and realistic objectives.

A. Collect and Review the Loan File

The start of the diligence process for a distressed real estate loan is assembly and review of loan files. Review tasks should include:

1. Record Review. Lender or its counsel should insure that all mortgages, UCC financing statements and, in connection with any acquisition financing, deeds or other transfer documents have been properly recorded by obtaining the applicable recording information for each instrument.
2. Cash Management Accounts. Lender should confirm that all cash management and reserve accounts have been properly established and that account control agreements have been executed and delivered. It was common in recent years given the velocity of transactions to make establishment of the lockbox account a “post closing” item. In more than a few occasions, difficulties dealing with Deposit Banks and finalizing documentation resulted in these accounts not being in place for months after the closing.
3. Other Post Closing Items. As noted earlier, it was common in recent years for Lenders to close loan transactions even though certain funding conditions had not been satisfied. In these cases, the Lender would require the Borrower to execute a post-closing letter in which the

²² See Section IX. In fact many A/B co-lender agreements include a clause commonly referred to as a **servicer override** that allows a servicer or special servicer to overrule decisions of the controlling holder if it determines that it must do so to comply with the **servicing standard** set forth in the applicable **servicing agreement**.

Borrower would agree to complete certain actions within a specified period after the closing. The risk with these post-closing letters is that the principals shift their focus after the closing and there is often little or no follow up on post-closing obligations. Often this means that post-closing obligations simply do not get performed.

4. Reviewing Title Insurance Policies. Since any distressed mortgage loan could ultimately end up in a foreclosure proceeding, the Lender should review the title insurance policy that it obtained at the closing in order to determine the limits of any protection that policy might afford. The types of exceptions to coverage set forth in a title policy vary from state to state as do the endorsements that provide additional or more specific coverage. Lender's counsel should review the policy as an initial step in determining whether there could be adverse interests in a foreclosure proceeding. For example, if, as is the case in some states, the title policy excludes coverage for mechanics' liens, the Lender needs to understand that any takeover of the property may require it to settle with unpaid contractors or suppliers. Likewise, if the title policy indicates that the property is subject to a set of covenants, conditions and restrictions or CC&Rs which are common to strip centers, office parks and industrial centers (and are not extinguished by a foreclosure), the lender must understand whether there are any procedural or other requirements that need to be satisfied upon a change of ownership and what the obligations of the lender would be if it takes title to the property.

In construction loans and other loans involving multiple advances, Lenders should also review whether title updates or down-date endorsements were obtained for each advance. A title policy provides protection against title encumbrances from the date of the policy backwards. Consequently, the later the date of the policy, the better. On the other hand, there can be questions in some jurisdictions as to the priority of a mortgage against other liens with respect to advances made after such liens are recorded. Lenders should be aware of whether they funded advances despite additional exceptions being disclosed on updated title searches and, if so, on what basis (*i.e.*, did Borrower or some other party agree to indemnify the Lender against the lien or did the title company agree to insure over the lien).

5. Reviewing Guaranties and other Credit Support. When a real estate loan is non-recourse, the Borrower has the ability to cut off its liability by simply allowing the Lender to foreclose and walking away from the

property. Guaranties, indemnities and other forms of credit support are exceptions to this paradigm and can provide critical leverage in workout negotiations. Lenders need to understand the potential exposure of parties beyond the Borrower in a foreclosure scenario. This investigation is in part a legal review (what guaranties and indemnities were signed and what obligations do they create) and in part a credit review (who signed the guaranties and indemnities and what is their current financial condition). As to the legal review, the Lender needs to focus on what the exact obligations are under guaranties or indemnities and what limitations may apply. For example, some completion guaranties also cover interest, property taxes and operating costs until completion. If a project is not completed, this could essentially mean that the completion guaranty covers the “carry” costs of the project until completion. When it comes to nonrecourse carve-out or “bad boy” guaranties, Lenders and their counsel must carefully review the carve-out events to determine whether and to what extent any may apply to create full or partial recourse liability on the part of the guarantor. As to the credit review, Lenders must look not only at the financial wherewithal of the guarantor but also at the potential impact (and therefore leverage) of a guaranty claim. In this cycle, Lenders have come to learn that customary financial reporting (e.g., balance sheet, income statement) for guarantors does not give adequate information as it fails to adequately disclose contingent liabilities. Similarly, Lenders have found that net worth tests and liquidity requirements in guaranties do not provide the full level of protection sought since a guarantor may satisfy a net worth test but may have granted completion or other guaranties on half a dozen other projects that are now in a similar state of distress. It is also generally the case that guaranties granted by individuals have provided Lenders with greater leverage in workouts than guaranties given by corporate entities. As in the case of General Growth Properties, a guaranty providing that the guarantor will be fully liable on the loan if the Borrower files for bankruptcy is of little value if the guarantor also files. On the other hand, individuals do not like to file for personal bankruptcy and generally do everything they can to avoid it. They are also very averse to having liens (even subordinate liens) slapped on vacation homes, yachts or stock holdings. As a result, the possibility of settlement of a guaranty (or for that matter, avoidance of a present claim on a guaranty) can be a powerful motivating factor for an individual guarantor.

6. Confirm Legal Descriptions in Security Documents. While this may seem like an odd time to perform this task, Lenders (or their counsel) should take the opportunity at the outset of a workout process to reconfirm the legal and collateral descriptions in their mortgages, financing statements and other security documents. As to legal descriptions, the description in the mortgage should be compared to the description of the insured estate in the title insurance policy and to the description contained in any survey obtained by the Lender. Financing statements should be reviewed to make sure that the description of collateral includes all items intended by the applicable mortgage or security agreement. A defective description can potentially mean that the Lender's security interest does not apply to all items of collateral intended.
7. Checking for Errors in Loan Documents. Errors in legal documents happen, no matter how good the law firm representing the Lender or how many people reviewed multiple drafts of the documents. The sheer volume of loan documents and velocity of transactions makes some level of error unavoidable. The time to identify mistakes and other issues in the files is before an enforcement action has begun. While few would dispute the validity of the foregoing statement, it is easier said than done. Most lenders would not want to engage their counsel to do a full review of the loan documents as it would be costly and may not uncover the errors anyway, particularly if the counsel that prepared the loan documents was doing the review.²³

Workout Issue: Whether to switch counsel when a loan goes over to workout. Different lenders have different philosophies over whether lenders should switch counsel when a loan becomes a workout. Those who think that different counsel should be used are concerned that deal counsel will be less likely to spot their own errors and more defensive about the adverse affects that could arise from their errors. Lenders who advocate keeping deal counsel do not want to lose the benefits of having a counsel that knows the deal and how it was made and worry about the incremental cost of getting new counsel up to speed. Some also believe that deal counsel has a vested interest in defending its deal

23 This is not to imply that the original counsel would try to gloss over issues. Rather, it merely reflects the fact that (i) review by those involved in the deal (lawyers and business people alike) tends to be colored by the fact that they know what the deal is supposed to say and tend to see it and (ii) for whatever reason, the deal team did not pick up the error before the closing making it less likely that they would pick it up after.

and will fight harder for a better outcome. Neither approach is right all of the time. Rather, the first question should be whether the Lender is comfortable with the workout experience and expertise of deal counsel. Having a vibrant loan origination practice does not guaranty workout expertise, particularly now when the market has been so good for so long. Without the experience and expertise, counsel is less likely to be able to come up with creative strategies and solutions when needed. If the Lender is comfortable with the expertise and experience of its deal counsel, it is probably best to stick with them unless and until a particular issue comes up with respect to the interpretation or application of the loan documents. If such an issue does arise, the Lender may want to reconsider whether it would benefit from a second opinion.

Perhaps the better way to start is to conduct a more focused review of the provisions and definitions most likely to be at issue in the workout. If a loan is approaching maturity, careful attention should be paid to any extension right provisions to determine whether all required conditions to extension have been properly set forth. Provisions addressing the application of cash from lockbox accounts and reserves and payment waterfalls are also frequently in dispute and should be reviewed. Lenders must assume that Borrowers will seek to capitalize on every inconsistency or ambiguity to create defenses in an enforcement action and the decision on whether to negotiate or enforce must factor in the risk created by these types of problems with loan documents. It may make sense, for example, to agree to a restructuring or forbear from enforcing for a period of time rather than encountering a problem that can't be cured during enforcement proceedings. The Lender should also remain aware of opportunities to correct errors and cure ambiguities should there be an agreement on restructuring and amendment of existing loan documents.

8. Check any Partial Releases. Additional issues arise in loans with respect to which there have been partial releases of collateral. Whether releasing condominium units as they sell, out-parcels in a retail center or easements or air rights, Lenders should revisit any partial releases at the outset of the workout process to insure that prior partial releases released only the intended portion of the collateral and no more. Mistakes have been made in which mortgages were inadvertently released in their entireties or the descriptions on the premises to be released and the premises to remain subject to the mortgage were reversed. While we

are not aware of any case in which a Borrower has been successfully able to assert that its property is no longer subject to a mortgage that was mistakenly released, there could be serious consequences to release errors if an intervening lien arises on the property or the Borrower ends up in bankruptcy.²⁴

It is generally a good idea to order a new title search at the start of a workout process. It is often advisable to obtain the new title from a different title company than the one that issued the policy at closing. Until recently, it was common that title companies would agree to omit certain exceptions to coverage based on behind the scenes indemnities by Borrower or Sponsor rather than a legal view that the particular exception was subordinate to the mortgage.

B. Identify Other Potentially Adverse Parties

1. Obtaining a New Title Search

Once it becomes clear that a loan is heading toward workout/default, the Lender should order a new title search of the applicable property. The new title search is the first step in determining which other parties may have to be dealt with in a workout. The title search will identify other creditors that have obtained liens against the property since the closing. Logically, if a property is in trouble, the mortgage lender is not likely to be the only party that is not getting paid. A new title search is particularly important in construction loan workouts as contractors have statutory rights to file liens against the property if they are not paid. The priority of these mechanics' liens varies from state to state (and often are based on the fact pattern specific to the transaction). However, even if mechanics' liens are subordinate to the mortgage, the claims of unpaid contractors will have to be addressed if the workout involves completing the project²⁵ or trying to sell condominium units.²⁶ Subordinate lien holders can be expected to try to defeat the Lender's claims for fees, expenses and default interest, and may challenge the Lender's priority.

24 In bankruptcy, the trustee or debtor-in-possession has the power to defeat any lien that could be defeated by a hypothetical lien creditor that files its lien on the date of the bankruptcy filing. Equitable arguments that the Borrower should not unjustly benefit from lenders mistake would not have any force since they would not benefit the lender against a lien creditor that was unaware of the mistake.

25 If the Lender needs to complete the project, it may be cheaper to make a deal with the existing unpaid contractor than to bring a new contractor onto the site.

26 The fact that the Lender's mortgage is prior to a mechanics' lien may be of little practical benefit if condo sales are being held up by liens on the unsold unit and foreclosure would put the sales contracts at risk (either because of the time it would take or state law that would give purchasers the right to rescind contracts based on a material adverse change to the condominium).

2. Other Potentially Adverse Parties

Other potentially adverse parties include tenants at the applicable property. Again, if the property owner is not performing its obligations as Borrower to the Lender it may also be defaulting in its obligations as landlord to the tenants. An aggrieved tenant has a remarkable ability to see the mortgage lender as an accomplice of, or even a co-conspirator with, the landlord/borrower rather than as another victim of the Borrower's failures. They will often seek to assert claims against the Lender that they have against the landlord/borrower (or seek to get out of their leases) before, during and after enforcement proceedings. These types of claims can be avoided by the Lender entering into a subordination, non-disturbance and attornment agreement or **SNDA**s with key tenants at the closing. A well crafted SNDA will limit the liability of a foreclosing mortgagee for claims that the tenant may have against the landlord that arose prior to the foreclosure. However, even if there is an SNDA in place the Lender should attempt to find out what the potential tenant claims are. Landlord/tenant relationships are long term and a potentially foreclosing Lender, like a purchaser, needs to know what it is getting into. Moreover, in recent years increasingly aggressive comments to SNDAs by strong tenants have led Lenders on many occasions to simply forego SNDAs rather than sign one that increased rather than limited the Lender's potential liability should it take title.

In deed in lieu, "friendly" foreclosures and other transactions involving consensual transfer of properties from Borrower to Lender, it is also advisable to obtain **estoppel certificates** from tenants. Most leases require the tenant upon request from the landlord to certify whether there are any uncured defaults by the landlord under the lease or other claims of the tenant against the landlord. They are called estoppel certificates because it is likely that if a tenant executed such a certificate stating that there were no defaults or claims, it would be estopped from suing later on a claim that pre-dated the certificate. By obtaining estoppel certificates, a Lender can factor in any issues raised into a negotiated settlement.

C. **Pre-Negotiation Agreements**

Before any substantive discussions begin between Borrower and Lender with respect to any potential workout or restructuring, the Lender should have the Borrower execute a **Pre-Negotiation Agreement**. Pre-Negotiation Agreements protect (a) statements made during open negotiation (such as a party's perception of the value of a property) from being admitted as evidence in any subsequent litigation and (b) against the "inadvertent deal" by providing that until there is a definitive deal in writing, signed by the parties, the Lender can enforce its remedies. Absent a Pre-Negotiation Agreement, the parties have to be much more guarded in what they say and what data they

produce as they must be mindful that it could be used as evidence against them. Also, it is quite common in litigation to enforce remedies for a Borrower to argue that the Lender promised an extension or that some deal had been agreed to by the parties on a restructuring. The Pre-Negotiation Agreement makes such an argument much more difficult. Bottom line

- » there is no downside to executing a Pre-Negotiation Agreement on either side of the table;
- » there may be upside in that Lender and Borrower can negotiate a deal.

A forbearance period can, but need not be built into a Pre-Negotiation Agreement. The Pre-Negotiation Agreement can, subject to negotiation, also contain a statement that there are no offsets, defenses or counterclaims and can provide for payment of Lender's legal fees. It's rare, however, to get these additional provisions agreed to by Borrower and a Lender should take care before delaying the execution of the Pre-Negotiation Agreement (and thus the start of the negotiation process) by insisting on these provisions.²⁷

D. Regulatory Effects of Non-Performing Loans

Lender decisions on workouts versus enforcement are also affected by the regulatory environment. Regulatory regimes and rules vary based on the jurisdiction regulating the applicable financial institution. While foreign banks must comply with U.S. regulations, their home jurisdiction will control for the purpose of determining when a loan becomes non-performing and what the consequences of that are. For US banks, a loan becomes non-performing 90 days after an Event of Default has occurred. When a loan becomes non-performing has both a legal impact and an institutional impact. Most jurisdictions require that additional reserves be set aside for non-performing loans and may require more detailed reporting and focus more intense regulatory scrutiny. Within a given bank, a loan becoming a non-performing loan may trigger transfer of responsibility for that loan from the normal loan administrators to a "special situations" or workout group.

Another critical factor impacting how Lenders address workouts can be when a particular Lender is required to "mark down" a loan. Some non-bank lenders mark their loans to market continuously. On the other end of the spectrum, we have had experience with some non-U.S. Lenders that were not required to write down loans until after the property was liquidated. It is easy to see how workout decisions could

²⁷ Of course, the leverage of the parties in each workout is different and there are certainly situations in which a Lender can successfully negotiate getting its fees paid or other concessions as a condition to coming to the table.

be impacted by whether or not the applicable Lender has already booked its loss. A Lender that has already marked the value of a \$100 loan to \$30 dollars and booked a \$70 loss may react differently to a offer by a Borrower to pay off the loan at \$35 (which would result in a \$5 profit) than would a Lender that still carried the same loan at \$100 and would have to book a \$65 loss if it accepted the Borrower's offer.

IV. DEEDS IN LIEU OF FORECLOSURE

A. Consensual Turnover

Strictly speaking, a deed in lieu of foreclosure or **deed in lieu** is not an exercise of the remedies that a Lender may have against a Borrower either at law or pursuant to its loan documents. Rather, it is a consensual and contractual agreement between the Borrower and the Lender pursuant to which the Borrower agrees to convey title to the property to the Lender (or an entity designated by the Lender), usually in exchange for some level of release of claims that the Lender may have against the Borrower. Deeds in lieu of foreclosure have become quite common in this cycle, partly because in many cases declines in value have become so severe that there can be no real dispute as to whether there is any remaining value in the Borrower's equity. In addition, many lenders have been willing to settle or release claims against guarantors in return for deeds in lieu. Finally, the provisions of nonrecourse carve-out guaranties can create real down side to Sponsors to fight foreclosure or file bankruptcy as means of creating delays to lever some concession from Lenders.

A deed in lieu transaction can be particularly helpful to a Lender in a jurisdiction that allows only judicial foreclosure.²⁸ In these jurisdictions, a foreclosure can take up to two years and cost a great deal in attorneys' fees. Of course, loan documents customarily obligate the Borrower to reimburse the Lender for its enforcement cost. However, if the property is already worth less than the debt and the loan is nonrecourse, adding attorneys' fees to the Lender's claim will not actually result in any additional recovery to the Lender. In these cases, the Lender may be willing to settle its claims against guarantors or provide some other inducement to obtain a deed in lieu and quickly gain control of the property.

Because a deed in lieu is a consensual transfer rather than a statutory or judicial process, it does not have the effect of extinguishing any other liens or claims against the subject property. A foreclosure, whether judicial or non-judicial terminates all interests in the property that are properly served or notified and are subordinate to the mortgage being foreclosed. When a Lender takes a deed in lieu it acquires the property

28 Judicial and non-judicial foreclosure are discussed in Section V infra.

subject to all liens and interests affecting that property. Consequently, a Lender must approach a deed in lieu transaction in the same manner as if it were purchasing a property outside the context of a loan.

A deed in lieu can also be subject to challenge if the Borrower files for bankruptcy sometime after transfer of title to the Lender (or its designee). The transfer can be attacked as a fraudulent transfer under state or federal bankruptcy law or as a preferential transfer under the Bankruptcy Code. If such an attack was successful, the transfer would be unwound and the Lender restored to its position as mortgagee.

B. Lender Protections

There are protections that Lenders can employ in deed in lieu transactions that limit the potential exposure of acquiring title to a property without the cleansing affect of a foreclosure. First and foremost, Lenders do not take title directly in a deed in lieu transaction. Rather, the Lender will form a new subsidiary (or, in the case of a syndicated loan, a new entity owned by the syndicate banks). As long as the new entity is properly formed, using the new entity to hold title can avoid direct liabilities that may be associated with a property.²⁹ It is one thing for a Lender to realize less in proceeds for a property taken back in a deed in lieu because of liens or encumbrances on the property. It is quite different for a Lender to have to come out of pocket for liabilities associated with the property.

Another technique employed by Lenders in deed in lieu transactions is to keep the mortgage in place when title is transferred to the newly formed entity. Keeping the mortgage in place gives the Lender a tool to extinguish unanticipated claims against the property. In many cases, the ability to foreclose is enough to obtain settlements from other lienors favorable to the Lender since these other claim holders know that they would be extinguished if the Lender decided to foreclose. However, preserving the mortgage is not fool proof. Other creditors could claim that because the mortgage is between affiliates it does not secure a bona fide debt or that it should be **equitably subordinated** to true third party claims.

Treating a deed in lieu transaction as a third party purchase also means that the Lender must update all property due diligence prior to consummating a deed in lieu. Diligence should include (i) a new title report, (ii) an updated **Phase I Environmental Assessment** (and, if warranted, a **Phase II Assessment**), (iii) a physical inspection,

²⁹ This may not always be the case with respect to environmental liabilities, which can attach to both owners and “operators” of environmentally contaminated properties. The new entity may be the owner but the lender could be found to be the operator if it is making all day-to-day decisions with respect to environmental issues.

(iv) tenant estoppels and (v) review of all contracts and agreements affecting the property. Additional diligence would be required in the case of an incomplete construction project as the Lender must also develop a view as to the cost and time necessary to complete. For hotel properties, the Lender should re-familiarize itself with the management agreement, particularly to determine whether the deed in lieu will create a right of the manager to terminate and whether the Lender has the right to terminate upon acquiring title in a deed in lieu. For condo projects, the Lender needs to understand the nature and extent of sponsor obligations that it will be taking on as a result of acquiring title and whether it will have to support those obligations with credit beyond that of the special purpose entity formed to take title. The Lender will also need to understand whether a deed in lieu will enable existing purchasers to rescind purchase and sale agreements for unsold units.

Finally, Lenders can provide some level of protection through the deed in lieu agreement with the Borrower and Sponsor. A deed in lieu must be documented in much the same way as any purchase and sale of property. Lenders can seek representations, warranties and indemnities with respect to the property. Since the Borrower will have essentially no assets after the closing of the deed in lieu, the Lender needs to seek these contractual protections from a guarantor or the Sponsor for them to have any practical value. Guarantors/Sponsors will strongly resist continuing liability once they have agreed to “give back the keys.” This can be a source of significant tension between the parties in deed in lieu negotiations. Much like purchase transactions, disputes arise with respect to the survival period for representations, thresholds and limits to liability and whose credit stands behind the representations and warranties. Continuing liability is at odds with a guarantor’s typical objective to gain a full release of its guaranty obligations in exchange for the deed in lieu. Many Lenders have addressed this conflict by substituting a **covenant not to sue** for a **release**. As its name implies, a release irrevocably waives claims that the releasing party has against the recipient of the release. In contrast, a covenant not to sue preserves any claims but creates an enforceable agreement not to attempt to collect on those claims. It can be irrevocable and unconditional or it can be made subject to ongoing conditions. For example, a covenant not to sue could be conditioned on the Borrower not breaching the representations and warranties set forth in the deed in lieu agreement with Lender.

C. Deed in Escrow

Today, when Lenders agree to a restructuring, they often require that the Borrower put a deed in lieu of foreclosure in escrow. The theory behind this requirement is that the Lender is foregoing commencing the remedy process to restructure the loan but should be entitled to a more expedited remedy path in exchange for agreeing to a restructure. By simply recording the escrowed deed the Lender can avoid a drawn out

exercise of remedies if another default occurs. Because title to the property remains in the Borrower until the terms of the escrow are completed and title transferred, many practitioners have long been concerned that this type of deed in escrow could be held by a court to be an “**equitable mortgage**”, which would mean that the Lender would still have to go through the foreclosure process. There is an added wrinkle in mortgage recording tax states.

A recent Tennessee bankruptcy case (*In Webb Mtn., LLC*, 2009 WL 425033 [Bankr. ED Tenn., Feb 11, 2009]), however, indicates that bankruptcy courts will recognize deeds in lieu of escrow as part of a loan workout. In *Webb Mtn.*, the bankruptcy court found that a deed in escrow, obtained as part of a valid extension and workout was valid and enforceable in accordance with the terms of the workout agreement. The court rejected Borrower’s argument that the conveyance was an “equitable mortgage” or a “clog” on Borrower’s right of redemption.

V. EXERCISE OF REMEDIES

A. Strategic Implications

As stated previously, the likely outcome of an exercise of remedies (be it foreclosure, bankruptcy or otherwise) must be the base case against which every other workout proposal, strategy or action must be evaluated. Even if a Lender is 100% successful in restructuring problem loans to avoid foreclosure or bankruptcy, it must understand how these remedy processes work to compare the benefits and risks of that approach to the benefits and risks of a negotiated settlement.

B. Foreclosure

The foreclosure remedy varies from state to state. Unlike bankruptcy, which is governed by federal law, foreclosure is a process governed by the laws of the situs of the property. Because a foreclosure directly impacts title to real property, courts in all states have consistently held that the parties cannot use a choice of law provision in a loan document to select a law other than the law of the state in which the property is located to govern the foreclosure.

There are two basic types of foreclosure: Judicial and Power of Sale. Within these two general types, however, there is a tremendous amount of variation. There is nothing like a Uniform Commercial Code to govern foreclosure. Rather, over many years, each state has developed its own, sometimes arcane and often idiosyncratic rules and procedures. While this Section deals with the general principles of judicial and power of sale foreclosure, a Lender needs to familiarize itself with the specific procedures

and requirements of the jurisdictions in which its real property collateral is located in order to accurately assess, the time frame, costs and risks associated with a possible foreclosure.

C. Judicial Foreclosure

As its name implies, judicial foreclosure is a litigation which is followed by a court ordered and supervised sale of the subject property. Since a successful foreclosure will extinguish the liens or title interests of every person subordinate to the mortgage being foreclosed, the process must be commenced by the lender serving process on every party that has a recorded interest in or lien on the property.³⁰ To identify the necessary parties, a Lender would typically order a **foreclosure title search**. Failure to serve a necessary party could mean having to start the process over if that party surfaces before the foreclosure sale or failing to extinguish the adverse party's lien if that party does not surface until after the foreclosure.

Because a judicial foreclosure is a litigation, typical litigation procedures and timelines apply. The process is commenced through the filing of a complaint and service of a summons. The Borrower has a certain period of time to respond to the Lender's complaint. Borrowers can dispute the Lender's claim of default and can also raise affirmative defenses and even make counterclaims against the Lender. In the past, counterclaims have included lender liability claims arising from the purported actions or inactions of the Lender. For example, in the past cycle Borrowers frequently argued that construction lenders wrongfully refused to fund advances which lead to an inability to complete and massive economic losses. Depending on the nature of the claims and counterclaims, there can be lengthy discovery and motion practice similar to any other commercial litigation. In the prior cycle it was common for foreclosure actions in New York to take two years or more to adjudicate.

The foreclosure sale process is not initiated until the Lender obtains a judgment of foreclosure from the court. The sale processes vary quite a bit from state to state and can be rather technical in their requirements. Notice of the sale must be given to the public. The sale itself is open to the public.

At a foreclosure sale, the Lender can **credit bid** up to the amount of the note. A credit bid means that the Lender does not actually have to fund cash. Since any cash paid by a purchaser at foreclosure would go to the Lender any way up to the amount that the Lender is owed, the Lender can bid up to that amount by simply crediting its bid against the amount it is owed. In contrast, a third party bidder must pay cash,

30 In some jurisdictions, parties whose interests are not recorded but would be discoverable by reasonable inquiry, such as tenants in possession, must also be served.

generally by certified or bank check and a 10% deposit is often required at the time of the sale. In most cases, there are few if any other bidders at a foreclosure sale. Lenders are not under any obligations to allow inspection of the property or provide diligence materials. They certainly do not provide any representations or warranties. The form of deed given to the purchaser at foreclosure is a referees deed or the equivalent. It is often difficult for a third party purchaser to have title insurance lined up in advance. For all of these reasons, most third parties otherwise interested in acquiring a property that was being foreclosed would prefer to let the Lender foreclose and then acquire the property from the lender with a normal diligence process and some contractual protections such as representations and warranties.³¹

If there are other bidders, however, a Lender will want to bid enough so that any third party bidder can't win for less than the note amount (including unpaid interest, costs and expenses).³²

Judicial foreclosure sales are confirmed by the court. Absent fraud or some clear bad act on the part of the mortgagee in conducting the sale, courts generally confirm any sale conducted in accordance with applicable local procedures. Lenders that acquire their collateral in foreclosure universally do so by forming a new entity owned by the lender or syndicate of lenders to hold the property. Doing so limits the liability of the Lender for claims arising from the ownership of the property so long as the limited liability nature of the subsidiary is respected. Care should be taken in structuring and operating these entities to insure that the lender cannot be held liable for claims against the subsidiary based on thin capitalization or other theories to pierce the veil of a limited liability entity.

D. Non-Judicial or Power of Sale Foreclosures

In non-judicial foreclosure, the property is sold in a public or private sale, depending on state law. The process and procedure vary from state to state but it does not involve the commencement of litigation or otherwise involve the courts. Non-judicial foreclosure is not available in every state. The Borrower must always be given notice and there is always some requirement that some form of public notice be given, usually publication in a newspaper, to ensure a reasonable opportunity for bidders. The publication requirement is often the most lengthy part of the procedure.

31 The exception would be an affiliate of the Borrower that already is familiar with the property and is using the foreclosure sale as an effort to acquire the property for less than the amount owed. A Lender that turned down an offer of a discounted pay-off may reconsider when the foreclosure sale is providing one last clear chance to avoid owning the property.

32 Unless, of course, the Lender is willing to take less than the full amount of the note.

The primary benefit of non-judicial foreclosure is that the process is significantly faster than judicial foreclosure – often 3-6 months. If the Borrower wants to stop the foreclosure, it must bring an action seeking to enjoin the sale or file bankruptcy. There are downsides, however. A Lender may be precluded by local law from seeking a **deficiency judgment** once it has chosen non-judicial foreclosure. That is, in judicial foreclosure, if the property sells at the foreclosure sale for an amount less than the amount owed to the Lender, the Lender can technically seek a judgment against the Borrower for the deficiency. In most cases, however, the legal right to seek a deficiency judgment is of little practical value since the loan was likely nonrecourse³³ and the Borrower likely has little or no assets other than the property. A Borrower could also seek to have the transfer of the property voided as a fraudulent conveyance arguing that the purchaser (usually the Lender) did not pay fair value for the property.

E. Rights of Redemption

A **right of redemption** is a Borrower's right to either stop or, in some cases, undo a foreclosure by paying the Lender what it is owed. Redemption rights can be either common law or statutory. They cannot be waived by the Borrower and any provision in loan documents purporting to waive rights of redemption is generally unenforceable. To redeem a property, however, the Borrower must pay all amounts owed under a loan, including late fees and default rate interest. In most states, closing of a foreclosure sale following a judicial foreclosure terminates the Borrower's right of redemption. In some states, however, redemption rights can survive a completed non-judicial foreclosure for some statutory period.

F. One-Action Rules

A “**one action rule**” is a state law that in one way or another restricts a Lender's options to sue a Borrower to enforce its debt or proceed against the collateral securing that debt. The most well known one action rule is found in California. In California, a non-judicial foreclosure cuts off any ability of the Lender to otherwise enforce its debt against the Borrower.³⁴ Less known though, is the fact that any action to collect the underlying debt could result in the loss of the Lender's ability to foreclose the mortgage. In one case, a Lender's use of its common law right to offset amounts owed to it against funds held in the Borrower's bank account, was held to terminate the right to foreclose against the property. Whenever the collateral includes real property in California, the Lender must take extra care to insure that it does not unintentionally forfeit rights and remedies.

33 Meaning that the Lender had contractually agreed to limit its remedies to the collateral.

34 Generally, the Lender can still sue guarantors of the debt.

While many Lenders are at least aware of California's one action rule, there are, in fact, almost as many variations on the one action rule as there are states that have it. In New York as Real Property Action and Proceedings Law, Section 1301 creates what would more accurately be described as a one action at a time rule. The law provides that a Lender cannot sue on the debt or on a guaranty of the debt at the same time as it forecloses on the Property. The law can force Lenders to balance their desire to gain control of their collateral with a need to pursue guaranties before other creditors acquire what may be limited assets of the guarantor.

Other states, like Nevada, have more limited one action rules. In Nevada, that means that if you put the appropriate waivers in a guaranty which is governed by the laws of a jurisdiction other than Nevada, you can enforce the deed of trust and the guaranty at once.

G. Receivership

Generally, the Borrower remains in control of the property until a foreclosure is completed. This can create serious negative impacts to the Lender if the property requires capital improvements or repairs, space is vacant or leases are expiring or the property otherwise requires some type of active management. The Borrower likely lacks the resources and certainly lacks any incentive to put any time or effort into a property that is being foreclosed. A Lender faces the likelihood that the value of the property can be deteriorated further during the foreclosure process.

To preserve its collateral during the foreclosure process, Lenders can seek the appointment of a receiver for the property. The appointment of a receiver terminates the Borrower's control over the property and its cash flow and transfers that control to the receiver. Rights of Lenders to obtain the appointment of a receiver vary from state to state. For example, some states historically required that the Lender make some showing that its security was being impaired by the Borrower's continued control of the property. Others did away with that requirement so long as the loan documents provide that the Lender is entitled to a receiver without such showing after an event of default. Generally, a receiver cannot be appointed unless there is some litigation pending so it can be difficult to obtain a receiver in a non-judicial foreclosure. At a minimum, the Lender would have to bring an action seeking the receiver's appointment, which reduces the time advantage of non-judicial foreclosure. In some states, a Lender can seek the appointment of a receiver without notifying Borrower or *ex parte* and in others, by notice and motion. In a notice and motion state, the Borrower will likely have something to say about the Lender's request.

State law also varies widely with respect to the degree of influence a Lender has over whom is appointed as receiver and the actions that receiver takes. A receiver is an officer of the court, not an agent of the Lender. In some states, receiver positions are doled out as political favors and a receiver appointed in a particular case may have little experience or competence in operating a complex commercial property. The receiver's authority derives from the court order appointing it. Ultimately, though, if a receiver and the Lender disagree on whether the receiver should take some action or incur an expense, the court will decide – and the sympathies of the court are far more likely to be on the side of the receiver. This can be a particular problem in cases in which the Lender is looking to aggressively reduce operating expenses. As a result, in many situations, having a receiver in place can be a double-edged sword.

Fees for receivers fees vary from state to state and can be quite expensive in some jurisdictions. Although fees are technically paid by the “case”, in practice this usually means that the Lender pays since the receiver has to be paid currently, the amount advanced by the Lender is added to its claim and the foreclosure generally does not fully pay the claim of the Lender.

H. Mortgagee-in-Possession

A Lender becomes a **mortgagee-in-possession** if, as the term implies, it takes over possession of a property prior to completion of a foreclosure or transfer of title by deed in lieu of foreclosure. A Lender can also become a mortgagee-in-possession without physically taking possession if it actions and rights with respect to the property evidence such a degree of control over that property that a court would conclude that the Lender, not the Borrower, is the true operator of the property. Mortgagee-in-possession is a concept that rarely arises and an area of the law few practitioners have actually encountered.³⁵

A mortgagee who takes possession of property does so under a doctrine of strict liability. The mortgagee becomes liable to all third party creditors of the property. The mortgagee also takes on a duty to account to the Borrower for its actions with respect to the property. In practice this means that the Borrower has the opportunity to second guess the actions of the Lender and sue for damages.

Given these potential liabilities, one might conclude that a Lender would never want to become a mortgagee-in-possession. However, like most general rules in the workout world, there are exceptions. The authors did, for example, advise a Lender to become a mortgagee-in-possession of a completed, but completely vacant office building.

35 The authors are among the few who have actually advised a client to take possession of a property as mortgagee-in-possession.

Although the loan agreement required the Borrower to use diligence to lease up the building, there is no practical way to enforce that type of affirmative obligation – *i.e.*, you cannot go to court and get a judge to order a Borrower to sign a particular lease. The property was in a jurisdiction that permitted only judicial foreclosure and the foreclosure period would be lengthy. The Lender was not willing to trust long term leasing decisions to a receiver and was also concerned about preventing damage to the building that could arise if elevators, HVAC and other building systems were not being used and maintained. In this particular instance the risks of letting the building lay fallow outweighed the potential liabilities that the Lender could take on as mortgagee-in-possession. Interestingly in that case, the Lender’s decision to take possession did motivate the Borrower to turn over the keys in a deed in lieu transaction.

VI. BANKRUPTCY

In the present cycle, Bankruptcy is the great bogey man that is threatened by Borrowers. In fact, bankruptcy was a very potent weapon used by Borrowers in the last downturn. It was effective largely because of the delay it created and before the extensive use of lockbox accounts, the uncertainty that would be created as to the Lender’s right to the cash produced from the property during the pendency of the bankruptcy.³⁶ While this guide is not intended to be a primer on bankruptcy,³⁷ a few key concepts and issues common to real estate bankruptcies are outlined below.³⁸

A. The Impacts of Bankruptcy

1. The Automatic Stay

The commencement of a case under the United States Bankruptcy Code automatically stays virtually every action that a Lender would otherwise consider taking to collect its loan or otherwise enforce the obligations of the Borrower under the loan documents. Actions subject to the automatic stay include foreclosure, UCC sale, recordation of additional mortgages and even demand letters or other notices. With respect to foreclosures, UCC sales and power of sale, if the sale has not been finalized, it is subject to the stay. It was common, for example, in the last downturn for Borrowers to delay a bankruptcy filing until the day before the foreclosure sale was scheduled to occur,

36 There were even cases, since overruled, that held that a Lender did not acquire a perfected security interest in rents by virtue of recording.

37 For a more detailed guide, the authors recommend [Bankruptcy: A Survival Guide for Lenders](#) published by the American Bankruptcy Institute and co-authored by Katten partner Kenneth E. Noble.

38 The discussion in this section is limited to the context of a Chapter 11 reorganization Proceeding as opposed to a Chapter 7 Liquidation.

thus presenting the Lender with the combination of the protracted foreclosure process followed by a protracted bankruptcy process.

The automatic stay remains in place until the conclusion of the bankruptcy case or it is lifted by the Bankruptcy Court. Bankruptcy Courts have granted relief from the automatic stay in real estate cases in which the only asset of the debtor was the property and the mortgage lender was able to clearly show that the property was worth substantially less than the amount of the loan – that is, a reorganization was impossible. However, given that appraisals are inexact and granting relief from the stay is tantamount to dismissal of the bankruptcy, the Bankruptcy Court is going to give the benefit of the doubt to the Borrower/debtor in any case in which the values are a legitimate issue. To obtain relief from the stay, a Lender must make a motion in the Bankruptcy Court which then holds a hearing.

2. Cash Collateral

Upon the commencement of a bankruptcy, funds held in a lockbox account or other reserve account in which the Lender has a valid and perfected security interest become **cash collateral** under Section 363(a) of the Bankruptcy Code. The significance of designating these funds as cash collateral is that use of the funds becomes governed by the Bankruptcy Code and order of the Bankruptcy Court. In fact, one of the first things that happens in a real estate bankruptcy is the negotiation/litigation of a cash collateral order. The flip side of the automatic stay for creditors is that once a debtor files for bankruptcy, it cannot pay even the smallest bill without approval of the Bankruptcy Court. In a real estate case, the cash collateral order will specify what the Borrower/debtor can and cannot do with the cash held in the lockbox and other reserve accounts. Many items will be non-controversial such as payment of operating expenses in accordance with a budget, taxes and insurance premiums, and can be negotiated between the Lender and bankrupt Borrower. The one issue, however, that will always put Borrowers and lenders at odds arises when the Borrower seeks to use cash collateral to pay its attorneys and consultants in the bankruptcy. Professional fees in bankruptcy can run in the millions of dollars and Lenders are justifiably upset with the prospect that their own collateral could be used to fight them. Under the Bankruptcy Code, the debtor can only use cash collateral (i) with the consent of the secured creditor that has the security interest in that cash collateral or (ii) pursuant to an order of the Bankruptcy Court. To grant such an order, the Bankruptcy Court must find that the secured creditor has adequate protection of its security interest notwithstanding the use of cash collateral. For example, in a case in which the value of the property exceeds the amount of the senior mortgage loan, the Bankruptcy Court could permit the use of cash collateral of the senior mortgage lender because it is adequately protected by the property value. In practice, in a real estate case in which the senior lender has a

security interest in basically all of the debtor's cash and there has been no successful motion for dismissal or relief from the stay, it is likely that the Bankruptcy Court will allow the debtor to use cash collateral to pay all or a portion of its professional fees.

Thus, the transfer of control over cash collateral from the Lender to the Bankruptcy Court following a bankruptcy filing by a Borrower creates risks that (i) cash will get applied to property-related expenses in different amount or proportions or at different times than would have been the case under the loan documents and (ii) a portion of the cash held in a lockbox or as reserves could be lost to fund professional fees in the case. It is generally not the case, however, that a Lender risks use of its cash collateral to make payments to equity or other classes of claims junior to it in priority.

3. Exclusivity

While much in the Bankruptcy Code deals with bankruptcy trustees, the use of a trustee is much more the exception than the rule. For the most part, when a company files bankruptcy it continues to administer its own business and affairs as a **debtor in possession**. One important right of a debtor in possession is that it is the only party that can propose and solicit votes for a plan of reorganization for a specified period. The **exclusivity period** for a debtor is 120 days to file a plan and 180 days to solicit acceptances of the plan if it is filed within 120 days. However, under the Code, the Bankruptcy Court can and routinely does extend the exclusivity period up to a maximum of 18 months to file a plan. Creditors do have the right to contest requests to extend exclusivity and even to terminate exclusivity before the 120 days have expired but they generally face an uphill battle.

4. Plan Approval/Cram Down

The Borrower's objective in filing a Chapter 11 Bankruptcy petition (aside from delaying its Lender and benefiting from the leverage created by doing so) is to confirm a plan of reorganization that will permit it to continue its business going forward. There are many requirements for confirmation, but here are the basics:

- » Creditors of the bankrupt debtor must be divided into classes. Similarly situated creditors, such as unsecured general creditors, employees and secured creditors should be placed in the same class (although secured creditors with liens on different collateral and secured creditors with different priorities would not generally be placed in the same class). Creditors do have the opportunity to object to the debtor's classifications.
- » Based on the terms of the Plan, each class of creditors will be either unimpaired or impaired. A class is **unimpaired** if the claims of the members of that class will either be paid in full at the closing of the Plan or will be paid

in accordance with the terms of the contracts binding such creditors prior to the bankruptcy. Unimpaired classes do not get to vote on the Plan. If a class is not unimpaired, it is **impaired**. That is, a class of creditors is impaired unless it is either getting paid in full at the closing of the Plan or the terms of its contract are being honored by the Plan.

- » A Plan cannot be confirmed unless at least one impaired class of creditors approves the plan. A class approves the plan if at least one half of the number of creditors in such class and holding two thirds of the total dollar amount of claims in that class vote for the plan.
- » For each impaired class, each creditor in such class must either approve the Plan or must receive under the Plan at least as much as it would have received under a liquidation of the debtor.
- » The Bankruptcy Court must determine that the Plan is feasible.

Given the foregoing, most Lenders would be thinking at this point that bankruptcy is not all that bad. After all, if the Lender is part of an impaired class the class must either approve the Plan or receive as much as it would otherwise receive in a liquidation – which for a mortgage lender would basically mean getting its property. However, the Bankruptcy Court has the power to confirm a Plan even if a class does not approve the Plan so long as

- » at least one impaired class approved the Plan;
- » the Plan does not discriminate unfairly; and
- » the Plan is “fair and equitable” to each non-accepting impaired class.

This power is commonly known as **cram down**. For secured creditors, “fair and equitable” means that the Plan must provide that the creditor retains its lien or security interest over its collateral and receives deferred cash payments totaling at least the value of its collateral as of the closing of the Plan. In practice, cram down creates the potential that a secured loan could be restructured by the Plan, including extending the term, revising or eliminating amortization requirements and adjusting the interest rate to a “market rate of interest”.

In sum then, a Borrower bankruptcy can (i) delay the Lender through the automatic stay and exclusivity period, (ii) modify the permitted uses of cash flow through the cash collateral order and (iii) potentially lead to an involuntary restructuring of the loan through the down. Given these down sides, it is little wonder why Lenders and their lawyers have spent a great deal of time and energy trying to come up with ways to avoid bankruptcy.

B. Can Bankruptcy be Avoided?

1. Bankruptcy Remote vs. Bankruptcy Proof/Special Purpose Entity

First and foremost, there is no such thing as a “bankruptcy proof” entity. Contractual provisions that prohibit an entity from filing bankruptcy are not enforceable. Instead, Lenders strive to ensure that their Borrowers in most real estate transactions are “**bankruptcy remote**”. Bankruptcy remoteness means that both the Borrower and the transaction are structured to minimize the risk of bankruptcy.

The most important requirement for bankruptcy remoteness is that the Borrower be a **special purpose entity** or **SPE**. Simply put, SPEs are organized such that their only activity is the ownership of the property that is the subject of the loan. Strictly speaking, the fact that an entity is an SPE does not make its bankruptcy any less likely. What it does mean is that if it does go bankrupt it will do so as a result of factors affecting the property that the Lender has underwritten – not some unrelated business venture. In many ways, having an SPE Borrower is the necessary quid pro quo for a Lender contractually limiting its recourse for a loan to the property. That is, if the Lender cannot look to the overall credit of the Sponsor for repayment, the Sponsor’s other ventures should not negatively impact repayment either. While Lenders often required this type of structure before the popularity of securitized lending, rating agencies standardized the requirement.

2. Separateness and Substantive Consolidation

Under the doctrine of substantive consolidation, a non-bankrupt entity can be dragged into the bankruptcy of its affiliate and the two entities treated as a single company in the bankruptcy. All of the assets and claims against the companies would be combined and any claims between the companies (such as intercompany loans) would be wiped out. The remedy of substantive consolidation is rarely invoked and generally only in cases in which the applicable entities have so ignored corporate formalities that there is no practical way to figure out who owns what or which creditors have claims against which entities. Notwithstanding the extraordinary nature of this remedy, substantive consolidation became a favorite issue of the rating agencies in securitized lending. The agencies would require that both the loan documents and the Borrower’s organizational documents include so-called **separateness covenants** and require legal opinions that the borrowing entity can’t be consolidated with its parent and affiliates in the case of a filing of any of them. The agencies developed a lengthy list of covenants derived from fact patterns in the few cases that ordered substantive consolidation.

The covenants would range from the sensible (such a covenants not to commingle cash flow or guaranty the debts of others) to somewhat silly (such as covenant to use separate stationary and fairly allocate office overhead among companies). Thus far, substantive consolidation has not shown to be a major issue in this downturn.³⁹

3. Independent Directors

In another attempt to achieve bankruptcy remoteness, the rating agencies also required that Borrowers have an independent director, manager or member without whose vote the Borrower could not file for bankruptcy. Like many structural attempts to avoid bankruptcy, use of independent directors has had limited utility. First, since many of the independent directors were supplied by companies created exclusively for that purpose, when bankruptcy became a possibility, they would simply resign. Bankruptcy courts do not favor mechanisms that restrict a debtor's access to bankruptcy and are unlikely to deny such access because the Borrower could not get the vote of a director that has resigned.⁴⁰ Second, and perhaps most importantly, a number of courts have held that a director has a fiduciary duty to the company. That fiduciary duty may require the independent director to vote in favor of a bankruptcy filing if it is in the best interest of the company. The independent director is not the agent of the Lender and cannot be counted on to vote "no" on bankruptcy.

4. Recourse Carve-Out Indemnities as a Disincentive to Filing

Perhaps the most effective way to avoid a bankruptcy filing by a Borrower is to have a nonrecourse carve-out guaranty that will impose personal liability on the guarantor if the Borrower does file. Generally, these guaranties work in one of two ways. Some nonrecourse care-out guaranties make the guarantor fully liable for the loan if the Borrower voluntarily files for bankruptcy. Others make the guarantor liable for the loss suffered by the Lender as a result f the filing. The latter formulation may be a less effective deterrent to filing. An argument can be made, for example, that if a bankruptcy results in a confirmed plan of reorganization, the Lender suffers no loss since it would have either approved the plan or the court would have held that the plan effectively protects its claim. While there have been few cases litigated so far, in at least one instance, a guaranty of full recourse has been upheld.

The effectiveness of nonrecourse carve-out guaranties is also affected by the nature of the guarantor. If the guarantor is a corporate entity that is itself about to file bankruptcy, the guaranty will be of little value in preventing a Borrower filing. Individuals,

39 *But see* discussion of GGP case in the Annex attached hereto.

40 Particularly if no one is willing to step up and replace the resigned director, as would often be the case in a distressed situation.

however, are very reluctant to file personal bankruptcy. Thus far, nonrecourse carve-out guaranties appear to be more effective in preventing Borrower bankruptcy.

5. Single Asset Real Estate Bankruptcy

In the most recent round of amendments to the Bankruptcy Code, the real estate lobby was able to create some exceptions to the general Chapter 11 process for single asset real estate cases. In cases in which the only significant asset of the debtor is a real estate project, the Bankruptcy Court must lift the stay unless within 90 days after the filing of the petition, (i) the debtor files a plan that has a reasonable possibility of being confirmed in a reasonable time, (ii) the debtor commences monthly interest payments to the Lender at the non-default contract rate. These changes grew from a general acknowledgement in the last downturn that the normal time periods for a Chapter 11 case were not necessary for single asset real estate cases (which are much simpler than the bankruptcy of a large operating company) and were being abused by debtors.

VII. BANKRUPTCY AS A WORKOUT TOOL — PRE-PACKAGED AND PRE-ARRANGED BANKRUPTCIES

A. **Pre-Packaged Bankruptcies**

Bankruptcy can actually be used as a tool by Lenders to implement agreed workouts and restructurings. In a “**pre-packaged bankruptcy**” the equity owners of the debtor and all major creditors reach an agreement as to what the plan will provide prior to filing the bankruptcy petition. In some cases the Reorganization Plan and Disclosure statement may be fully drafted and voting takes place pre-petition. Debtor can even schedule a hearing date for confirmation of the plan on the first day of filing. A pre-packaged bankruptcy providing for the transfer of the property to the lender can actually be faster than a foreclosure while providing all the benefits of extinguishing other claims. Pre-packaged bankruptcies can even be tax efficient since transfers of real property pursuant to a confirmed bankruptcy plan are exempt from state transfer taxes.⁴¹

B. **Pre-Arranged Bankruptcies**

A pre-arranged bankruptcy is similar to a pre-packaged bankruptcy except not all creditors have reached agreement. Instead, the key stakeholders enter into a Plan Support Agreement setting forth the terms of the agreed plan. Because not all creditors are brought on board, the plan cannot be drafted pre-petition and no voting can occur.

41 Pre-packaged Plans, however, can not be done for the sole purpose of tax avoidance.

VIII. WORKOUTS OF SYNDICATED LOANS

A. Nature and Structure of Syndicated Loans

Syndicated Lending broadly refers to loans that are either made or held by a group or **syndicate** of Lenders. Syndicates can either be assembled prior to closing of the loan, or an originating lender can make the loan and sell off pieces after the closing or some combination of the two. Syndication can be accomplished either by issuing each co-lender its own note executed by the Borrower (either at the closing or following a partial assignment by another lender to that lender) or by having one bank act as lender and issue **participation interests** in the loan to the other syndicate lenders. A holder of a participation interest does not have a direct contractual relationship with the Borrower, could not sue the Borrower directly to collect the loan and may not have a separate claim to vote in a Borrower bankruptcy.⁴² For these reasons, most Lenders prefer to be co-lenders and hold their own notes, although participation interests did regain some popularity in the last lending cycle, in part, because participation interests are generally subject to lesser transfer restrictions than direct interests in a loan.

Generally, a syndicated loan will be structured to establish one lender as the primary administrator of the loan and point of contact for the Borrower. In co-lender structures, this party is the **Administrative Agent** or **Agent**. In participation structures it is the lead lender. For purposes of this discussion, the term Agent will be used to refer to both the Agent in a multi-lender transaction or the lead lender in a participation structure.

B. Powers of the Agent

In a typical syndicated loan transaction, fairly broad powers and discretion are delegated to the Agent. The loan documents are usually structured such that the Agent is delegated the full power and authority to make all decisions, grant all consents or waivers and make remedial decisions, except for a limited amount of modifications, consents or waivers for which consent of either a majority, a supermajority (usually 66.67%) or, in some cases all of the Lenders is required. Most commonly, unanimous consent of the Lenders is required to:

- » Increase the amount of the loan or the commitment of any of the Lenders;

42 Historically, there was also a concern that a participation interest may not represent a beneficial interest in the underlying loan. Instead, it was argued that a participation interest was just a contractual claim against the lead lender, meaning that a participant took lead lender credit risk in addition to Borrower credit risk. Development of case law and changes to the Bankruptcy Code now make it clear that a properly drafted participation agreement does grant the participant a beneficial ownership interest in the loan.

- » Extend the maturity of the loan other than pursuant to extension options set forth in the loan documents;
- » Reduce the interest rate;
- » Waive or postpone any monetary obligation of the Borrower; or
- » Release the collateral securing the loan.

While these may seem like rather limited rights on the part the Lenders, they can prove to be significant obstacles to concluding a restructuring. Many restructurings (particularly in this cycle) include an extension of the maturity of the loan. That feature alone would mean that the Agent would need 100% consent from the Lenders to conclude the restructuring. Reduction or accrual of interest are also common features of restructurings that would trigger a unanimous consent right.

C. Herding Cats

The requirement to obtain unanimous Lender consent to restructure a syndicated financing can prove to be extraordinarily difficult given today's syndicates. One of the biggest changes in syndicated financing from the last downturn to the present is the composition of the syndicates. In the early 90s, lending syndicates were comprised almost entirely of banks. Even then differences in regulatory regimes between U.S. and non-U.S. banks and in strategic approaches made restructuring syndicated loans tough. It was not uncommon, for example, for lenders with a small portion of a larger facility to use its unanimous consent requirements to block a restructuring and lever the other lenders to purchase its interest. Today's syndicates are comprised of domestic and foreign banks, investment banks, hedge funds, real estate funds, mortgage REITs and even securitization vehicles such as **CDOs**. There is also far more secondary trading of syndicated loan interests in today's market than was the case 15-20 years ago. When a syndicated loan goes into distress one would not be surprised to find that the syndicate includes Lenders that have written the loan down to zero and Lenders that still carry it at par; Lenders that were part of the original closing and Lenders that acquired their interest at a steep discount; Lenders that are themselves in distress (and, in some cases, have been more or less nationalized), Lenders that are winding down their business and Lenders that are solid and expect to return to making loans when conditions improve. Getting such a disparate group to consensus on the terms of a restructuring (or on restructuring at all versus exercise of remedies) can, at times, be like herding cats. It's not impossible but it requires a great deal of time, effort and skill.

D. Agent Conflicts

Another change in syndicated lending in this cycle is the frequency in which Agents find themselves in positions of conflict or potential conflict. Historically, concerns

about Agent conflicts of interest were focused on conflicts that arose because the Agent had substantial other dealings with a sponsor group that could impact its decision-making. Those concerns still exist today but they pale in comparison to the potential conflicts that arise in present financings because Agent banks play multiple roles in the capital structure. It is quite common in today's multi-tranched financings for an a bank to act as the Agent for a senior mortgage loan and simultaneously hold positions in one or more of the mezzanine loans. In fact, there have been transactions in which the originating Lender successfully syndicated 100% of the mortgage loan, held the mezzanine loan and remained the Agent for the mortgage loan. Unfortunately, if the Agent does not view a situation like this as a conflict, there is little the Lenders can do to force the Agent to resign. Most loan documents give the Lenders the right to remove the Agent only upon the Agent's gross negligence or willful misconduct. They do not require the Agent to resign in situations that create actual or potential conflicts of interest.

IX. WORKOUTS OF SECURITIZED AND MULTI-TRANCHE LOANS

The biggest impact of securitization in real estate finance has been the dispersion of risk associated with a given real estate loan. Before securitization, risk could be spread among a handful of lenders or participants in a lending syndicate. With securitization, the risk on the senior mortgage loan alone could be spread among hundreds of bondholders, some of which were themselves funds or securitization vehicles. The risk could be further dispersed by adding on A/B Structures and multiple layers of mezzanine loans which could also be securitized through offerings of collateralized debt obligations or CDOs. Unfortunately, this dispersion of risk also resulted in a dispersion of authority to administer real estate loans and a separation of administrative authority and economic interest that adversely impacts the ability to workout or restructure securitized loans.

A. Role of the Servicer

When a Loan is placed into a pool in connection with an offering of Commercial Mortgage-Backed Securities, control of the Loan moves from the originating Lender to a Master Servicer. Master Servicers are set up primarily to process and administer, not make decisions. Their fees reflect that role and are very small.

B. Special Servicers

When that same Loan becomes a **Specially Serviced Loan**, responsibility for administration of the Loan transfers to the Special Servicer. Under a typical Pooling and

Servicing Agreement, a Loan becomes a “Specially Serviced Loan” when:

1. There is a maturity default;
2. There is a monetary default that has continued beyond 60-90 days;
3. The Master Servicer concludes that there is an imminent risk of a monetary default that will continue beyond 60-90 days;
4. There is a material non-monetary Event of Default that the Master Servicer concludes is adverse to the interests of the CMBS holders;
5. There is a Borrower bankruptcy; or
6. The Special Servicer has all of the authority after the loan becomes a Specially Serviced Loan but no authority before.

C. Authority/Servicing Standards

Since the definition is quite specific and somewhat restrictive, we are seeing scenarios in which Borrowers that are trying to be proactive with restructuring proposals have no one to speak to. The Master Servicer is not equipped or authorized to do loan restructurings. The Special Servicer has no authority until the Loan becomes a Specially Serviced Loan. As a result, a proactive Borrower trying to restructure a securitized loan prior to default can become very frustrated.

D. Impediments to Workouts

While Special Servicers have authority, they have little or no incentive to restructure Loans. They are bound by very general **Servicing Standards** which often come down to a mandate to maximize the expected net present value of the recovery on the loans. However, while the Servicing Standard is pretty broad, a Special Servicer would have potential exposure to CMBS holders if it agreed to restructure a Loan, the restructuring failed and security holders wound up with a lesser recovery than would have been the case if the Special Servicer went immediately to foreclosure. While the risk may be quite small, there is no upside to a Special Servicer from a restructuring and there is no risk to the Special Servicer to proceed directly to an exercise of remedies.

E. REMIC Rules

Until recently, the ability to restructure loans that had been contributed to a CMBS securitization was also inhibited by applicable tax rules. The vast majority of CMBS securitizations were structured to qualify as Real Estate Mortgage Investment Conduits or **REMICs**. By qualifying as a REMIC, the issuer could issue multiple classes of securities and avoid having the pool itself taxed as an entity. Unfortunately, rules

governing REMIC qualification sharply limited a servicer's ability to modify loans in the pool prior to an actual default. Recently, the IRS issued new REMIC regulations and a revenue procedure permitting greater flexibility in modifying loans generally and where default is reasonably foreseeable, including at maturity. These modifications should largely remove REMIC rules as a barrier to restructurings by servicers. They do not, however, do anything to modify the incentives to servicers or the risk/reward analysis that servicers must perform when considering a restructuring.

X. MEZZANINE LOANS

A. Structural Subordination

Workouts of so-called mezzanine loans involve additional complexities that arise from the structure of these loans and the nature of the security. A mezzanine loan is generally not secured by a lien on the underlying real property.⁴³ Rather, mezzanine loans are made to the parent company of the property owner and are secured by a pledge of the ownership interests of the property-owning entity.⁴⁴ Because the mezzanine loan is not secured by any lien on the property and is in fact made to the parent of the mortgage Borrower rather than the mortgage Borrower, the mezzanine Lender would generally not be considered a creditor of the property owner/mortgage Borrower. In that respect, mezzanine loans are often described as “**structurally subordinate**” to mortgage loans.

While mezzanine loans existed prior to the advent of commercial mortgage-backed securities, their popularity exploded with the growth of CMBS loans. Rating agencies established eligibility criteria for mortgage loans to be included in CMBS pools. These criteria included maximum loan-to-value ratios and minimum debt service coverage ratios. Notwithstanding these eligibility limits, property owners sought higher leverage and there were Lenders in the market that were willing to lend at higher LTVs and lower DSCRs. Borrowers did not want to give up the low interest rates provided by CMBS financing so they sought financing to supplement a CMBS mortgage loan and take the property leverage from 65-70% of value to 85-85% (or higher). Since the rating agencies would also not allow second mortgages on CMBS loans, the answer was mezzanine financing. Initially mezzanine loans would command almost

43 There are instances in which mezzanine loans are secured, *inter alia*, by a second mortgage on the underlying real property but these are not common.

44 If the property owner is a limited liability company (or LLC), the mezzanine loan will be secured by the membership interests in the LLC. If the property owner is a limited partnership, the mezzanine loan will be secured by the limited partnership interests and the shares or membership interests in the general partner.

equity-like interest rates. However, over the course of the boom, competition among mezzanine lenders and easy access to capital drove mezzanine loan interest rates to levels only slightly higher than first mortgage loan rates.

B. UCC Foreclosure

For the most part, real property is owned through limited liability companies, limited partnerships or corporations. In each case, membership interests, partnership interests and shares are personal property and security interests in these types of personal property are governed by the Uniform Commercial Code (*UCC*). The UCC provides that personal property collateral subject to a security interest under the UCC can be sold following a default under the underlying obligation in a public or private sale often referred to as a “UCC Sale or a “UCC Foreclosure”. The UCC Sale process is generally much faster than mortgage foreclosure. The overriding requirement of the UCC is that the UCC Sale must be “commercially reasonable.” That generally means that there must be reasonable notice to the Borrower and the terms of the sale must be reasonable. Reasonable notice can be stipulated in the security agreement and can be as little as ten days in a private sale. Public sales require some form of advertising or public notice – often in one or more newspapers of general circulation. It is easier for a mezzanine Lender to acquire the pledged interest directly through credit bidding in a public sale than a private sale as private sales raise issues of valuation of the collateral. Both public sales and private sales are non-judicial. Consequently, if a mezzanine Borrower wants to stop the sale it is the one that must commence a litigation seeking an injunction against that sale.

The increasing frequency of mezzanine foreclosures and UCC Sales in this cycle has led to the appearance of a number of companies whose business is to assist lenders in conducting UCC Sales. These companies are usually affiliated with real estate brokers. For a relatively small fee, they will put together a small offering brochure on the interest being sold, handle newspaper advertising and email the offer to a data base comprised of thousands of potential bidders. These companies may not increase the likelihood that anyone will actually show up at an UCC Sale and make a bid that the Lender would be willing to accept, but they do help to create a strong defense to any subsequent attack by the Borrower that the UCC Sale was not conducted in a reasonable manner.

If the mezzanine Lender exercises remedies against its collateral it does not become the owner of the real property – it becomes the owner of the owner of the property. A mezzanine “foreclosure” does not wipe out any liens encumbering the real property. In fact, because the mezzanine Lender effectively steps into the shoes of the property owner, it is structurally subordinate to both the secured and unsecured creditors of

the property owner. Any workout strategy for a mezzanine Lender must include a means to identify the superior creditors and a plan for dealing with them. For that reason, a mezzanine “foreclosure” is often more the beginning of the workout process than the end.

C. Intercreditor Agreement Issues

Mezzanine loans are, by and large, incremental financing to mortgage loans. Even though mortgage loans and mezzanine loans are made to different Borrowers and have different security, mortgage loans and mezzanine loans do have potential impacts upon each other. Customarily, the mortgage Lender and the mezzanine Lender on any particular project or portfolio will enter into an intercreditor agreement to address these potential impacts.

From the standpoint of the mezzanine Lender, the intercreditor agreement accomplishes a number of objectives. First, the intercreditor agreement provides a consent of the mortgage Lender to the mezzanine loan, which would otherwise violate restrictions on indebtedness set forth in the mortgage loan documents. Second, the intercreditor agreement sets forth a stipulation by the mortgage Lender that a default under the mezzanine loan does not cross default to the mortgage loan. In contrast, a default under the mortgage loan would cross default the mezzanine loan. Third, intercreditor agreements provide the mezzanine Lender with limited rights to cure defaults under the mortgage loan and an option to purchase the mortgage loan that is typically triggered by acceleration or an enforcement action by the mortgage Lender.

From the prospective of the mortgage Lender as well, the intercreditor agreement serves various purposes. Most importantly, the intercreditor agreement confirms the subordination of the mezzanine loan to the mortgage loan and typically addresses in detail the consequences of a bankruptcy of the mortgage Borrower. Pursuant to the Bankruptcy Code, these subordination agreements between creditors of a bankrupt debtor are enforceable. Also, the intercreditor agreement specifies the terms and conditions under which the mezzanine Lender can enforce its remedies and take control of the mortgage Borrower without defaulting the mortgage loan. Finally, the intercreditor agreement generally restricts the mezzanine Lender’s right to transfer the mezzanine loan without consent of the mortgage Lender (or for mortgage loans that are part of a securitized pool, a rating confirmation) to transferees that meet a specified definition of “Qualified Transferee” designed to include only larger institutional Lenders.

Intercreditor agreements also generally restrict both the mortgage Lender and mezzanine Lender from making certain fundamental changes to the terms of the mortgage loan or mezzanine loan, as applicable without the consent of the other.

Frequently, there will be an exception to these restrictions for modifications made by the mortgage Lender in connection with a “workout” after the occurrence of an event of default under the mortgage loan. In those circumstances, a much smaller subset of prohibited modifications would apply. In most cases, however, if the Senior Loan is in default, the Mezzanine Loan is as well.⁴⁵ In these cases, the practical reality is that the Mezzanine Lender will not be able to restructure the Mezzanine Loan without addressing the default under the Senior Loan and the Senior Lender cannot conclude a restructuring with the Borrower without the Mezzanine Lender either restructuring the Mezzanine Loan or at least agreeing to waive the default under the Mezzanine Loan.

D. Options when the Mezzanine Loan is Out of the Money

Unfortunately, it is all too common in today’s market for a Mezzanine Lender to find that the value of the property is not sufficient to cover the mortgage loan (or senior mezzanine levels) ahead of it, much less the Mezzanine Loan. Although the Mezzanine Loan is out of the money in these cases, it does not necessarily mean that there is no value in the position of the Mezzanine Lender. First and foremost, a Mezzanine Lender still has the ability to wipe out the Borrower’s interest in the property through a mezzanine foreclosure. This creates leverage for the Mezzanine Lender in transactions in which the Senior Lender is happy with the current sponsorship because the Senior Lender cannot accomplish a restructuring with the Sponsor without the acquiescence of the Mezzanine Lender. Moreover, since the Mezzanine Lender did not execute a nonrecourse carve-out guaranty for the benefit of the Senior Lender, it would not incur any personal liability under the Senior Loan if it chose to file the property owner in bankruptcy immediately after acquiring the ownership of that entity through the UCC Sale. This tactic is more effective if the property value is close to the amount of the Senior Loan.⁴⁶ Finally, if the Senior Lender is inclined to foreclose the mortgage but the property is located in a state that allows only judicial foreclosure, the Senior Lender may be interested in purchasing the mezzanine loan for some small amount so that it could obtain control of the property more quickly. The price that a Senior Lender would be willing to pay in such a circumstance would be a function of the costs of foreclosure (since there is no extra value in the property to reimburse legal fees) and the perceived cost of the delay that a foreclosure would involve.

45 In fact, a properly structured Mezzanine Loan would include a cross default provision to the Senior Loan.

46 If the property is clearly worth less than the mortgage loan, the mortgage lender may seek relief from the stay in bankruptcy on the grounds that no reorganization is feasible.

XI. SPECIAL ISSUES IN CONSTRUCTION LOAN WORKOUTS

This is one area that has kept those of us who practice in the New York Metropolitan area busy.

A. Cost Overruns/Loan Balancing

- » The obligations to balance can be approached in different ways in loan documents.
 1. As a condition to further advances, Borrower will try at all costs to avoid missing payments to contractors and tax payments. Keep in mind timetables during which residential construction must be completed to comply with condominium laws as well as 421a and J51 type of tax abatements.
 2. Requirements of a Shortfall Deposit.
 - Sometimes these are in Lender's reasonable discretion and sometimes they are arbitrary decisions on the Lender's part. A guaranty of completion should require the guarantor to make a shortfall payment at that time as well.
 - It's easier said than done to actually get the funds put up as Borrowers will dispute the findings.
 - A Lender needs to have an experienced construction consultant who is carefully monitoring the course of construction.
 - The Lender has to be certain it has held back for retainage.

B. Change Order Analysis

Most loan documents contain provisions for caps on change orders both individually and in the aggregate without Lenders consent. However, we have discovered during this cycle that general contractors have presented change orders to Borrowers, who reject them orally.

- » At the end of construction, when the developer tries to close out accounts, Lenders often get presented with a pile of change orders, which have been implemented (even though the clear language of most Lenders agreements with contractors makes it clear that Lenders must consent to changes of such magnitude). Borrower will have "rejected" such changes.

- » How can a Lender avoid this type of situation? Loan proceeds have been advanced; the project is close to completion and the contractors have threatened to lien the project because they have not been paid – Monitor, Monitor, Monitor. Make sure your consultant talks with contractors.

C. Mechanics' Lien Issues

- » Depending on state law, your counsel have undoubtedly taken appropriate steps to be certain that construction loan advances prime mechanics liens.
- » In addition to that, the general contract/subs have been bonded.
- » What can go wrong?
 - See undisclosed change orders in Section B above.
 - Before the economy melted down, your Borrower came to you (this even happens occasionally today) and told you that if the mechanics' lien is not removed, they will be unable to close sale contracts.
 - The Borrower can terminate the general contract or the bonding company will look for ways out of their obligation.

D. Completion Guaranties

As additional security, construction Lenders often require a **completion guaranty** from a creditworthy party in place. Typically, completions guaranties are drafted as one might expect – the guarantor guaranties completion of the specified improvements in accordance with the applicable plans and specifications. Unfortunately, they simply do not work that way. Courts simply cannot undertake the degree of involvement that would be necessary if they were to specifically enforce a completion obligation. Imagine, having to go to court each time there was a dispute on a change order. In response, many lenders have crafted their completion guaranties more specifically as guaranties of cost overruns. Here again, Lenders have encountered difficulties in enforcing these guaranties. By and large, if a Borrower fails to honor a shortfall call, Lenders have not been able to go to court and get the court to force the guarantor to honor the obligation. There is little new case law on completion guaranties, but a couple of themes have emerged. First, courts have been sensitive to efforts by Lenders to effectively convert a completion guaranty to a principal guaranty. In one such case, the court rejected a Lender's effort to enforce a completion guaranty as a damage claim after it had foreclosed on the property and sold it. Second, courts are reluctant to enforce completion guaranties in circumstances in which the Lender does not actually complete the particular project.

XII. SPECIAL ISSUES IN HOTEL WORKOUTS

Hotels are an operating business. They have a unique set of issues. A hotel in workout requires a specialist for adequate analysis and advice.

A. The Management Agreement

This is a key document in any workout.

1. Does the manager have a non-disturbance agreement?
2. Does the management agreement permit the Lender to terminate upon an Event of Default or a foreclosure? Those have become extinct in recent years.
3. How does the manager's compensation work? Can they get an "equity return"?
4. Is the hotel worth more with the manager in place than on its own?
5. Does the manager use brand standard materials?
6. Has the manager agreed that your hotel will be treated fairly in terms of union contracts?
7. Do you have approval over changes in the competitive set?
8. Sometimes a Lender can negotiate better provisions than an owner can.

B. Liquor Licenses

1. While Lenders take pledges of liquor licenses, the transfer of some are subject to approval by the local authority.
 - Only a few jurisdictions permit effective pledges.
 - They are rarely transferred at the time of closing – follow up.
 - Managers may be the ones with liquor licenses – that raises issues re: manager termination.

XIII. SPECIAL ISSUES IN CONDOMINIUM LOAN WORKOUTS

Many of us have been involved in condominium workouts. Those that are under construction or have recently been completed are in trouble.

A. Sponsor Obligations

Before a Lender takes over a condominium project, the Lender should check state law. In New York, for example, the party taking over the property will become liable for sponsorship obligations. Certain amendments, including a new sponsor, require approval of the attorney general or analogous authority. Failure to follow requirements may result in allowing purchasers to walk away from contracts.

B. Preserving Sales Contracts

Preserving existing sales contracts will also depend on state law. Each state has requirements in terms of when construction must be completed, for example. There are also requirements under the Interstate Land Sales Act, which affects projects of more than 100 units.

C. Exit Strategies

A Lender who sees a problem coming has to decide whether or not to permit a conversion to a condominium regime. There are two alternatives for a failed condominium project – cut sales prices and sell as many units as possible or convert the project to a rental. Neither one repays the underlying loan. The one place a Lender does not want to find itself is with a limited number of unit owners objecting to rentals.

- » It will be difficult to get end user financing. Some Lenders have end-loan programs. However, Freddie Mac, which only bought loans in projects where 50 of the units were sold has moved the “to be sold” requirement to 75%.

D. Deposits

A purchaser may be entitled to receive the return of its deposit if the developer has not lived up to the terms of the contract or local law. It is becoming the norm today for purchasers to sue to get deposits back in all events. They use grounds such as failure to comply with contract obligations.

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Experience

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Ms. Chromow attended Barnard College and received her B.A. in 1968 and earned her J.D. from New York University School of Law in 1971. She is admitted to practice in New York.

Lectures

Columbia University Summer Terrace Series, Panelist on “Restructuring Hurdles – Legal and Regulatory Issues” (*June 23, 2009*)

Harvard University Executive Education Program, Panelist on “Distressed Real Estate Debt and Equity” (*July 22–23, 2009*)

Memberships & Affiliations

Advisory Board – New York University Law School Furman Real Estate Institute

Advisory Board – New York University Women’s Initiative

WX – Women Executives in Real Estate

Honors & Recognition

Euromoney Institutional Investor PLC – *Expert Guides in Real Estate 2006*

Madison Who's Who Among Executives & Professionals – *2008–2009 Honor's Edition*

Cambridge Who's Who – *Expert Guides in Real Estate 2006*

Marquis Who's Who in America – *2009 Edition*

Presidential Who's Who Among Business and Professional Achievers – *2008–2009 Edition*

The Legal Media Group Guide to the World's Leading Real Estate Lawyers – *2008 & 2010 Editions*

Lawdragon 500 Leading Lawyers in America Finalist – *2008*

The Best Lawyers in America in the specialty of Real Estate – *2010 Edition*

Presidential Who's Who Among Business and Professional Achievers – *2010 Edition*

New York Magazine Top Attorneys in New York, New Jersey and Connecticut – *2010 Edition*

Publications

“Real Estate Ownership: A Series of Cycles,” a chapter in *Inside the Minds: Winning Legal Strategies for Real Estate: Leading Lawyers on Securing Financing, Structuring Contracts, and Ensuring Successful Transactions* (Aspatore Books, 2005)

“Getting The Deal Through, Real Estate in 30 jurisdictions worldwide” – *contributing editor, January 2008, 2009*

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Mr. Little received a B.S., with highest honors, from Cook College of Rutgers University in 1982 and earned his J.D., *magna cum laude*, from Harvard Law School in 1985. He is admitted to practice in New Jersey and New York.

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