

DISTRESSED COMMERCIAL REAL ESTATE LOAN WORKOUTS
AND REMEDIES – TODAY'S INSIGHTS AND STRATEGIES

by

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Distressed Commercial Real Estate Loan Workouts and Remedies -- Today's Insights and Strategies[©]

- I. Initial Steps -- Inquiries -- Planning**
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II. Defaults and Acceleration

- A. Material Defaults
 - 1. Maturity
 - 2. Non-Payment of Debt Service
 - 3. Non-Payment of Real Estate Taxes/Escrows
 - 4. Non-Payment of Insurance Premiums

5. Material Breach of Debt Service Coverage Ratio Covenant
 6. Loss or Diminution of or Change in Insurance Coverage (e.g., Terrorism Exclusion)
 7. Damage to Mortgaged Property
 8. Impermissible Subordinate Financing
 9. Transfer of Mortgaged Property
 10. Violation of Environmental Indemnity
 11. Material Adverse Change in Financial Condition (“MAC Default”) (but see [B][6] below)
 12. Fraud
- B. De Minimus Defaults
1. Failure to Deliver Financial Statements (Timely, at All)
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 4. Death of Guarantor
 5. Erosion of Cash Flow
 6. Material Adverse Change in Financial Condition
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- C. Evaluation of Efficacy of Material Adverse Change Covenant in this Economic Cycle
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- E. Notice of Acceleration
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 2. Overt
 3. Unequivocal
- F. Mechanics and Effect of Acceleration
1. Imposition of Default Rate of Interest

- 2. No Obligation to Accept Partial Tender or Borrower's Cure of its Default
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- G. Return of Subsequent Debt Service Payments
- H. Course of Conduct Relating to Past Defaults
 - 1. Ramifications of Sudden Shift in Position or Use of Remedies
 - 2. Covenant to Act in Good Faith and Deal Fairly

III. Enforcement of Guaranties

- A. Promise to Pay the Obligations of Another
- B. Can be Unconditional or Limited (Partial)
- C. The Guaranty as Leverage for Borrower's Commitment to the Property and to Repayment
- D. "Honor" isn't Enough
- E. Joint and Several Guarantors
- F. Independent of Obligations of Borrower
- G. Partial Payment Guaranty -- Make Sure Guaranty Covers Last, Not First, Obligations
- H. Construction Completion Guaranty
- I. Full or Partial Debt Service Guaranty
- J. Financial (or Other) Covenants Guaranty
- K. Guaranty "Burn off" if Benchmarks (or Milestones), such as Leasing, are Met
- L. Use of "Bad Boy" Springing Guaranties for "Non-Recourse" Exceptions
 - 1. A "Bad Boy" Guaranty Provides for Personal Liability against Principals of Borrower upon the Occurrence of Certain Enumerated "Bad Acts"
 - 2. Principal or Affiliate Would Have No Obligation to Repay the Loan (i.e., "Non-Recourse") Unless There Was Some "Bad" Act
 - 3. This is a Behavior Modification (a "Bad" Act) -- Not a Credit Enhancement
- M. Doctrine of Novation
- N. Ratification of Guaranties -- Implications and Waivers

- O. Beware of Conduct, or Course of Conduct, that Releases Guarantors
- P. “Carveouts” as a Negotiation Device

IV. Common “Bad Boy” Triggers (“Non-Recourse Exceptions”)

- A. Fraud or Misrepresentation
- B. Diversion of Cash Flow -- Misappropriation of Rents or Revenues
- C. Environmental Liability
- D. Interference by Borrower or Guarantor with Legal Remedies
- E. Material Alteration of Collateral
- F. Waste (or Mismanagement)
- G. Filing Bankruptcy (or Soliciting an Involuntary Bankruptcy)
- H. Modification of Borrower’s Articles or Organization
- I. Violation of “SPE” (Special Purpose Entity) or “Separateness” Covenants
- J. Difference Between “Actual Losses” and “Entire Debt” Categories of Recourse

V. Nature of “Bad Boy” Guaranty of a “Non-Recourse” Real Estate Loan

- A. The “Actual Losses” Bucket (Liability Limited to Lender’s Actual Damages)
 - 1. Fraud or Misrepresentation
 - 2. Misappropriation of Revenue
 - 3. Misappropriation of Condemnation Awards or Insurance Proceeds
 - 4. Failure to Turn Over Income or Revenues from the Property During an Event of Default
 - 5. Acceptance of More than One Month’s Advance Rent
 - 6. Physical Waste
 - 7. Failure to Pay Real Estate Taxes or Insurance Premiums
 - 8. Objection to Non-Judicial Foreclosure, if Applicable

- B. “Entire Debt” Bucket (Liability for Entire Indebtedness)
 - 1. Voluntary Bankruptcy
 - 2. Involuntary Bankruptcy Commenced Against Borrower or Guarantor
 - 3. Prohibited Transfer of the Mortgaged Property
 - 4. Breach of the Special Purpose Entity Covenants
 - 5. Interference with Mortgage Foreclosure Remedy
 - 6. Insolvency -- (?) -- see *Cherryland* Discussion (below)

- C. Bad Boy Guaranties are Enforceable
 - 1. EVERY Reported Decision (Except Two -- see *ING v. Park Avenue Hotel* and *CP III Rincon Towers v. Cohen* below) Enforces Them
 - (a) *Bank of America, N.A. v. Lightstone Holdings, LLC*, 32 Misc.3d 1244(A), 938 N.Y.S.2d 225 (Sup. Ct. N.Y. Co. 2011)
 - (b) *G3-Purves Street v. Thomas Purves*, 101 A.D.3d 37 (2d Dep’t 2012)
 - (c) *USB Commercial Mortgage Trust -- FLI v. Garrison Special Opportunities Fund L.P.*, 938 N.Y.S.2d 230, 2011 N.Y. Slip Op. 51774 (Sup. Ct. N.Y. Co. 2011)
 - (d) *Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. Partnership*, 812 N.W. 2d 799 (Mich.App. 2011)
 - (e) *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC*, 835 F.Supp. 2d 384 (E.D. Mich. 2011)
 - (f) *Bank of America N.A. v. Freed*, 2012 IL App. (1st) 110749 (Ill. App. First Dist. 2012)
 - (g) *Wells Fargo Bank N.A. v. Mitchell’s Park*, 2012 WL 4899888 (N.D. Ga. 2012)
 - (h) *Turnberry Residential Ltd. Partner v. Wilmington Trust*, 33 Misc.3d 1220 (A) (Sup. Ct. N.Y. Co. 2011), *affd*, 99 A.D.3d 176, 950 N.Y.S.2d 362 (1st Dept. 2012)

- (i) *LaSalle Bank v. Pace*, 2011 BL 358538 (Sup. Ct. N.Y. Co. 2011) *affd*, 100 A.D.3d 970, 955 N.Y.S.2d 161 (2d Dept. 2012)
- (j) *Blue Hills Office Park v. JPMorgan Chase Bank*, 477 F. Supp. 2d 366 (D. Mass. 2007)
- (k) *CSFB 2001-CP-4 Princeton Park Corporate Center v. SB Rental I*, 410 N.J. Super. 114, 980 A.2d 1(App. Div. 2009)
- (l) *Wertheimer Mall*, 2008 U.S. Dist LEXIS 64152 (S.D.N.Y. 2008)
- (m) *111 Debt Acq. v. 6 Venture*, 2009 U.S. Dist. LEXIS 11851 (E.D. Ohio 2009)
- (n) *Diamond Pt. v. Wells Fargo*, 929 A.2d 932 (Md. 2007)
- (o) *Potomac v. Green*, 2099 WL 1537853 (M.D. Ala. 2009)
- (p) *Federal Deposit Insurance Corp. v. Prince George Corp.*, 58 F.3d 1041 (4th Cir. 1995)

2. Equity Arguments Against Enforceability

- (a) The basic objections:
 - (i) Unfair
 - (ii) Unconscionable
 - (iii) Inequitable
 - (iv) Oppressive
 - (v) Void as against public policy
 - (vi) Frustrates constitutional right to file for bankruptcy
 - (vii) These arguments are generally not held successful or persuasive to a court, especially in business context

3. Implication of “Bad Acts” Committed by Third Parties

- (a) New equity owner can cause personal liability for former equity owner without any repercussions

- (i) “Bad boy” guaranty seems to lose its purpose -- original guarantor did not perform a “bad act”
- (ii) Unintended consequences in connection with mezzanine financing
- (iii) Mezzanine lender purchasing controlling equity stake can force defaults triggering “bad boy” guaranty
 - Put borrower in bankruptcy to trigger defaults
 - Use threat of putting borrower in bankruptcy or triggering other default in negotiations with first lien lender
 - Party in control of directing borrower’s actions should be responsible for guaranty in order for guaranty to be effective

4. But See

- (a) Stuyvesant Town decision -- *Bank of America, N.A. v. PSW NYC LLC*, 2010 NY Slip Op. 51848(U) [29 Misc. 3d 1216(A)], September 16, 2010 (Supreme Court, New York County, Lowe, J.)
- (b) Rule -- mezzanine lender must cure defaults (including full payment upon acceleration or maturity) under first mortgage loan before pursuing remedies

D. *Cherryland* (Court of App. Michigan) -- Is Non-Recourse Now Rendered an Illusory Concept?

- 1. Insolvency as “Bad Boy” Guaranty Trigger
 - (a) The “bad boy” guaranty required borrower to maintain its “SPE status”
 - (b) “SPE status” required borrower to “remain solvent”

2. Definition of Insolvency
 - (a) Liabilities exceed assets -- or
 - (b) Unable to pay debts as they come due
 - (c) "Every" distressed real estate owner "is" insolvent (fair market value is less than indebtedness)
 - (d) Makes every defaulted loan potentially fully recourse without regard to actions of the borrower
 - (e) Consequences of *Cherryland* are dramatic
 - (i) The decision makes non-recourse loans into recourse loans -- this was not the intention in the CMBS market
 - (ii) Creates full guarantor liability without a "bad act," based solely on value or market forces outside borrower's control
 - (iii) *Cherryland* injects uncertainty into a market where "bad boy" recourse was the standard operating procedure
 - (iv) Future of nonrecourse CMBS financings jeopardized
 - (v) \$700 billion loans already outstanding which would be susceptible to recourse claims upon default for insolvency
 - (vi) \$500 billion in defaulted loans that have been foreclosed or even taken in lieu of foreclosure but statute of limitations for suit on nonrecourse guaranty have not expired
 - (vii) Fiduciary obligation of special servicers (who are bound to obtain maximum recovery under CMBS pooling and servicing agreements) -- contractually required to pursue guarantors of insolvent SPE borrowers

- (viii) Avalanche of potential litigation
 - (ix) Adverse accounting implications for sponsors, borrowers and guarantors due to recourse versus nonrecourse nature and treatment of commercial mortgage debt on financial statements
 - (x) Chill and destabilize rebirth of CMBS
 - 3. *Chesterfield* -- Federal Court in Michigan, December 2011 -- same outcome
 - 4. Michigan Non-Recourse Mortgage Loan Act, (Chapter 445 of Act 67 of 2012, effective March 29, 2012)
- E. *ING v. Park Avenue Hotel* (610 Lexington Avenue), 26 Misc. 3d 1226(A), 907 N.Y.S.2d 437, Sup. Ct. N.Y. Co. (2010)
 - 1. “Bad boy” Guaranty Provided (i) Borrower May Not Incur Secured or Unsecured Indebtedness, Except as Provided in Loan Agreement; and (ii) Borrower has 20-Day “Safe Harbor” to Cure Certain Defaults
 - 2. Borrower was 19 Days Late on a \$300M Real Estate Tax Installment Payment
 - 3. Borrower Cured Tax Arrears on Day 20
 - 4. Lender Sued Guarantor for Entire Indebtedness under Bad Boy Guaranty; Debt was \$145MM; Fair Market Value was \$55MM -- Deficiency was \$90MM
 - 5. Court Held “Bad Boy” Guaranty WAS AN “Unenforceable Penalty”
 - (a) Immediate liability for the entire debt is not a reasonable measure of any probable loss associated with the delinquent payment of \$300,000 in real estate taxes when compared to a \$90 million deficiency

- (b) The Court's analysis:
 - (i) A commercial agreement should not be interpreted in a commercially unreasonable manner or contrary to the reasonable expectations of the parties
 - (ii) Immediate liability for the entire debt is not a reasonable measure of any probable loss associated with delinquent payment of a relatively small amount of taxes
 - (iii) "Such an unlikely outcome could not have been intended by the parties, sophisticated commercial borrowers and lenders aided by competent counsel at the time of the drafting, and is impermissible under New York law."

6. Post-Script -- Borrower "Purchased" the Loan at a Discount (of \$75MM)

F. *CP III Rincon Towers v. Cohen*, 10 Civ. 4638 (S.D.N.Y. April 7, 2014)

- 1. Bad boy guaranty provided full recourse for "unpermitted indebtedness" and voluntary liens, in addition to customary full-recourses events such as bankruptcy, fraud, impermissible transfers, etc.
- 2. Mechanic's liens were filed; they became judgments
- 3. After foreclosure auction, there was a \$40 million deficiency
- 4. Lender sought full recourse against the guarantor
- 5. The Court held that mechanic's liens are not "voluntary" liens
 - (a) The borrower disputed the liens
 - (b) A mechanic's lien is "inherently involuntary"

6. Mechanic's liens do not trigger full recourse under the "transfer" provision -- to do so would render the prohibition on "voluntary" transfers superfluous
7. Implications
 - (a) Mechanic's liens and judgments will not trigger full recourse
 - (b) The penalty -- full recourse for a deficiency -- is disproportionate to the wrong-doing

VI. Considerations in Dealing with Borrowers -- How Far to Go -- Lender Liability Risks

- A. Preliminary Considerations
 1. Review Credit File -- Internal Memoranda
 2. Review Loan Administration/History
 3. Availability of Loan Officers as Witnesses
 4. Attorney-Client Privilege
 5. Admissions Against Interest
 6. Pre-Workout Agreements
- B. Right to Protect and Preserve Collateral
 1. Request for and Review of Financial Statements
 2. Review of Books and Records
 3. Understanding Borrower's Operations, Business
 4. Insurance Coverage
 5. Protective Advances
 6. Real Estate Taxes
 7. Insurance
 8. Essential Repairs
 9. Appraisal of Property
 10. Right to Inspect Collateral
 11. Right to Approve Budgets (as Part of Restructure)
 12. Right to Receive Release Prices for Existing or New Collateral
- C. Covenant of Good Faith and Fair Dealing and Certain Borrower Defenses Relating Thereto
 1. Inherent in All Contracts and Negotiations
 2. Duty to Act Consistently

3. Cannot Convey False Sense of Security
 4. Cannot Reverse Established Course of Dealing
 5. Misrepresentation by Loan Officers
 6. Agreement to Waive or Not to Enforce Rights --
Forbearance -- Estoppel
 7. Detrimental Reliance by Borrower
 8. Oral Negotiations
 9. Overreaching, Duress, Bad Faith, Unequal
Bargaining Position
 10. Economic Duress (Pledge of Collateral for Default
Cure, New Loan)
- D. Imposition of Fiduciary Duty on Lender
1. Fiduciary Duty Generally Does Not Exist
 2. Relationship is Lender-Borrower, Creditor-Debtor
 3. Criteria for Fiduciary Relationship
 - (a) Long-standing relationship of trust
 - (b) Reasonable reliance on lender to protect
interests
 - (c) Lender offers business advice
 - (d) Lender participates in management of
borrower's business
 - (e) Lender takes ownership interest (rather than
security interest)
 - (f) Lender assumes position resembling that of
controlling shareholder
 - (g) Lender obtains powers over borrower
through pledge of voting stock as collateral
or through restrictions contained in loan
agreement
 4. Duty to Regulate and Monitor Extension of Credit
 - (a) Borrower's ability to service debt and repay
 - (b) Borrower's suitability and sophistication
 - (c) Suitability of the credit product
- E. Lender's Control over Business Affairs of Borrower
1. Instrumentality or Alter Ego Doctrine

- (a) Lender responsible for debts/obligations of borrower
 - (b) Difficult to prove
 - (c) Must show lender assumed “actual participatory total control”
- 2. Partnership -- Joint Venture
 - (a) Share in profits/losses
 - (b) Equity kickers (but not if interest on loan)
 - (c) Maintain control of underlying project
- 3. Assumption of Duty
 - (a) Mismanagement, negligence
 - (b) Daily Operations -- directives or recommendations from lender
 - (c) Duty to act with reasonable care
- 4. Fraud -- Standards
 - (a) Misrepresentation
 - (b) Falsity
 - (c) Knowledge of falsity
 - (d) Borrower’s reliance
 - (e) Damages
- F. Impermissible Interference with Borrower’s Business Affairs
 - 1. Offering Business Advice
 - 2. Participating in Management of Borrower’s Business
 - 3. Taking Ownership Interest (i.e., Share in Profits/Losses) Rather than Security Interest
 - 4. Assuming Position Resembling that of Controlling Shareholder
 - (a) Compelling borrower to execute contracts
 - (b) Hiring contractors
 - (c) Renegotiating existing contracts
 - (d) Requiring approval for payments of operations

- G. Tortious Interference
 - 1. Dealing with Borrower's Corporate Governance
 - 2. Usurping Management Responsibility and Control
 - (a) Requiring officers to take salary reductions
 - (b) Requiring borrower to replace management company, accountant
 - (c) Requiring approval for payments for operations
 - 3. Controlling Elections of Officers and Directors
 - 4. Dealing with Third Party Contractors
 - (a) Business or contractual relationship
 - 5. Interference with Valid Contract or "Prospective Contractual Advantage"
 - (a) Defense of "justification"
 - (b) Malice required for interference with prospective contractual advantage
- H. Credit Crisis Implications and Defenses – And Beyond
 - 1. Good Faith Steps to Refinance or Perform
 - 2. Impossibility of Performance
 - 3. Contracting Tenancies
 - 4. Densification
- I. Suitability of Participants as Lenders
 - 1. Major Decisions
 - 2. Voting and Control
 - 3. "Veto Power" and the Doctrine of Reasonableness

VII. Judicial Foreclosure

- A. Real Estate Loan Documentation -- Default and Remedy-Related Provisions
 - 1. Typical Provisions of the Commercial Mortgage
 - (a) Property related
 - (i) Description of collateral
 - (ii) Insurance
 - (iii) Protective advances as part of debt
 - (iv) Real estate taxes; tax escrow

- (v) Borrower to maintain and preserve premises
- (vi) Mortgagee's right to inspect/ appraise
- (b) Debt related
 - (i) Borrower to pay the debt (incorporates note)
 - (ii) Default rate interest
 - (iii) Late charges
 - (iv) Attorneys' fees
 - (v) Prepayment prohibition v. prepayment premium (usually in the note)
- (c) Remedy related
 - (i) Events of default
 - Non-payment of debt
 - Insurance -- casualty, terrorism issues/ requirements
 - Real estate taxes
 - Damage to property
 - Failure to maintain property
 - Subordinate financing
 - Transfer of property
 - Environmental violation
 - Non-delivery of financial statements
 - Monetary judgment
 - Material adverse change in financial condition
 - (ii) Right to accelerate
 - (iii) Right to foreclose
 - (iv) Entire debt secured by mortgage
 - (v) Receivership -- without notice
 - (vi) Assignment of leases and rents (additional collateral)
 - (vii) Due on sale

- (viii) Foreclosure sale in one parcel
- (d) Lender protections
 - (i) Borrower to furnish financial statements
 - (ii) Non-waiver of lender's rights
 - (iii) Usury savings clause/limitation on interest
 - (iv) No further encumbrances: prohibition on subordinate financing
 - (v) No oral modification

B. Counsel's Considerations Prior to Commencement of Foreclosure

1. Audit Mortgage Loan Documents
2. Perfection of Lien
3. Collateral Assignments
4. Credit File -- Internal Memoranda
5. Loan Administration/History
6. Course of Conduct Determinations
7. Admissions Against Interest
8. Understand Underlying Transaction/Collateral
9. Ascertain Lender's Goals, Objectives, Priorities and Capabilities
10. Determine Borrower's Objectives, Capabilities and Resources
11. Availability of Loan Officers, Witnesses
12. Guarantors/Subordinate Lienors/Tenants -- Necessary Parties Defendant
13. Environmental Reports
14. Evaluate the Market

C. Review of Multi-Creditor Relationships

1. Participation Agreements
2. Syndication Agreements -- Agent Obligations
3. Agent's Duty of Care and Fiduciary Responsibilities to Syndicate Members

4. Special Servicers
 - (a) Requirement for “default”
 - (b) Restrictions on loan modifications
 - (c) Remedies
 - (d) Risks
 - (e) “Servicer Paralysis”
 5. Mezzanine Loans -- Intercreditor Agreements
- D. Starting the Foreclosure
1. Review Loan Documents
 - (a) Recourse
 - (b) Non-Recourse
 - (c) Recourse carve-outs
 - (d) Springing guaranties
 - (e) Execution, perfection, modification
 2. Order Foreclosure Search -- Update Prior to Filing
 3. Determine the Parties to the Lawsuit
 - (a) Maker
 - (b) Mortgagor
 - (c) Guarantor
 - (d) Subordinate lienholders
 - (e) Subsequent owner (“new debtor syndrome”)
 - (f) Judgment holders
 - (g) Tenants
 - (h) Municipality
 4. Election Not to Foreclose Anchor or Market Tenants or Distant Judgment Creditors
 5. Non-Disturbance Agreements
- E. Summons and Verified Complaint
1. Parties (Name All Defendants, John Doe Defendants)
 2. Necessary Parties v. Permissible Parties
 3. Describe Mortgage History
 4. Describe Collateral being Foreclosed with Particularity
 5. Causes of Action for Foreclosure

6. Ask for Receiver
 7. Ask for Deficiency Judgment
 8. Separate Cause of Action on Guaranties
 9. Update the Foreclosure Search
- F. The Notice of Pendency (in General)
1. Unique Real Property Device
 2. Available in All Actions Affecting Title to or Use, Possession or Enjoyment of Real Property
 3. Effective for Three Years -- Can be Renewed (in New York)
 4. Grounds for Cancellation
 5. Improper Use -- Slander of Title
- G. Effect of Filing of Notice of Pendency
1. Notice to Subsequent Encumbrancers/Lienors
 2. "Bound as if a Party" to the Foreclosure
 3. Impact on Marketing Efforts
 4. Third Party Approach to Lender
 5. Sale of the Loan
 6. Title Insurance
 7. "New Debtor"
- H. Election of Remedies
1. New York Law
 - (a) Requires an election
 - (i) Either foreclose the mortgage or sue the guarantor
 - (ii) Cannot do both simultaneously
 - (b) If "elect" to sue the guarantor cannot start the foreclosure until the action on the guaranty is complete
 - (i) Execution on judgment must be returned "unsatisfied"
 - (ii) This is the consequence of the election of remedies doctrine

- (c) If “elect” to foreclose, guarantor is named in the foreclosure action for a deficiency (Phase II -- after foreclosure sale, guarantor liable for amount by which debt exceeds purchase price or value of property)
 - 2. Hot Tip -- “Unless the Court Orders Otherwise” -- RPAPL 1301(3) -- “Without Leave of Court”
 - (a) Where it is known there will be a deficiency, ask the court for permission to sue the guarantor for the deficiency simultaneously with the foreclosure
 - (b) Example:
 - (i) At origination -- \$80MM loan; \$100MM fair market value
 - (ii) At foreclosure -- \$80MM loan; \$50MM fair market value
 - (iii) \$10MM partial guaranty
 - (iv) There will be a \$30MM deficiency; ask the court for permission to sue guarantor for \$10MM
 - 3. Cases Support this Practice -- see *Investors Warranty of America v. Maclara*, Index No. 1958/10, Sup. Ct. Nassau Co. February 18, 2010
 - 4. Common Approach
 - (a) Invariably the lender will elect to foreclose its collateral first and name the guarantor for the deficiency
 - (b) The loan is underwritten on the strength of the (income--producing) collateral
 - (c) Receivership in foreclosure protects the lender against a diversion of cash flow
 - (d) Real Estate Tax Delinquency, Insurance, and Threats to Security and Priority of the Mortgage -- Catastrophic Loss -- Crisis Management
- I. Summary Compendium of Foreclosure Defenses and Lender Liability Theories of Recovery
1. Classic Lender Liability

- (a) Oral modification
- (b) Waiver and estoppel
- (c) On-going negotiations
- (d) Agreement not to enforce rights
- (e) Unconscionability, duress, overreaching, unequal bargaining position
- (f) Fraud
- (g) Actions taken in bad faith
- (h) Standards of good faith and fair dealing
- (i) Detrimental reliance
- (j) Course of conduct, reversal of established course
- (k) Tortious interference with contract
- (l) Tortious interference with prospective contractual advantage
- (m) Joint venturer or partner -- mezzanine loans in particular
- (n) Breach of fiduciary duties
- (o) Excessive lending (duty to curtail, moderate or investigate borrower's financial condition)
- (p) Misrepresentation or misleading statements by loan officers
- (q) Lender's duty to act consistently and not to give a false sense of security
- (r) Impermissible interference with borrower's business affairs
- (s) Lender as borrower and mezzanine lender -- fiduciary duties, conflict of interest
- (t) Clogging the equity of redemption

2. "New Lender Liability"

- (a) Proof of ownership of note
- (b) Standing to Sue
- (c) "Robo Signing" affidavits
- (d) "Robo Verifying"

- (e) Cutting corners in foreclosure process -- fraud
- (f) Affiant's lack of personal knowledge
- (g) Defective foreclosures
- (h) Loan participant suitability
- (i) Chain of title defenses -- Ibanez
- (j) Impossibility of performance
- (k) Force majeure
- (l) Doctrine of "deepening insolvency" -- fraudulent expansion of corporate life
- (m) "Loan to own" activities

J. Class Action "Hot Themes"

- 1. Predatory Lending
- 2. Sub-Prime Considerations
- 3. Rate Re-Set
- 4. Anti-Flipping
- 5. Fax Charges -- "Junk Fees"
- 6. Unauthorized Practice of Law (Charging a Fee for Preparation of Documents by Non-Lawyer)

K. Second Mortgage's Rights

- 1. Participate in Foreclosure ("Piggy-back")
- 2. Distributions out of Proceeds
- 3. Right to Cure First Mortgage Defaults
 - (a) Need subordination agreement
 - (b) Avoid imposition of default rate interest on first mortgage (erosion of equity)
 - (c) Default under second mortgage
- 4. Acceleration of Second Mortgage
- 5. Separate Foreclosure Action on Second Mortgage
- 6. Foreclosure Strategies as Holder of First and Second Mortgages
 - (a) Foreclose subordinate, "subject to" first mortgage
 - (b) Foreclose first only -- wipes out second
 - (c) Separate causes of action on each mortgage

- (d) Valuation of property
 - 7. Notice of Default to First Mortgagee Not Necessary
 - 8. Consent of First Mortgagee to Subsequent Second Mortgage
- L. Lender's Exercise of Assignment of Rents
 - 1. Revocation of Borrower's License to Collect
 - 2. Demand for Turnover of Rent
 - 3. Notice to Tenants
 - 4. Mortgagee-in-Possession
 - 5. Perfection of Security Interest in Rent/Cash Collateral/Standards
 - 6. Lock Box Arrangement -- Joint Notice to Tenants
- M. Interim Revenue Agreements in Lieu of Receivership
 - 1. Cash Flow Mortgage
 - 2. Approved Budget
 - 3. Approved Expenditures
 - 4. Extraordinary Expenditures/Reserve
 - 5. Lender's Control of Decisions
 - 6. Lock Box
 - 7. License to Collect Revenue; Termination of License
- N. Receivership
 - 1. Procedures, Effectiveness and Strategy in Seeking Appointment
 - 2. New Rules in New York Receiverships
 - (a) 22 NYCRR Section 36
 - (i) Receiver cannot be related to the appointing judge
 - (ii) The court makes/approves all appointments -- managing agent; receiver's counsel
 - (iii) Limits number of receivership appointments
 - 3. Perfection of Security Interest/Cash Collateral
 - 4. Managing Agent, Commissions, Collection of Rent
 - 5. Preservation of Security

6. Assignment of Rents, Defenses to Exercise
 7. Consensual Receivership
 8. Designation of Property Manager
 9. Receiver as Officer of the Court
 10. Receiver's Right to Make Necessary Repairs
 11. Shortfall in Receiver's Account
 12. Receiver's Discharge
 13. Alternative of Coordinated Collection Efforts
- O. Judgment of Foreclosure and Sale
1. Establishes Liability for the Debt
 2. Directs Sale of Mortgaged Property
 3. Affidavit of Regularity in Support
 4. Delete John Doe Defendants
 5. Referee Sells the Mortgaged Property
 6. Sale is Subject to Certain Encumbrances
 7. Provides for Distribution of Proceeds
 8. Plaintiff May Credit Bid
 9. Liability for Deficiency Judgment is Established
 10. Directs Purchaser be Put in Possession
 11. Right of Redemption
- P. Auction and Sale
1. Notice of Sale
 - (a) Publication
 - (b) Service on Parties
 2. Terms of Sale
 3. Memorandum of Sale -- Binding Contract
 4. Auction at the Courthouse
 5. Closing -- Referee's Deed
 6. Effectiveness of Referee's Deed
- Q. Assignment of Bid
1. Prior to Closing
 2. Tax Advantages
 3. Non-Ownership Advantages
 4. Disadvantages -- Ownership "Limbo"

5. Continuance of Receivership
- R. Deficiency Judgment Proceedings
 1. Recourse to Maker/Guarantor -- Recourse Events
 2. Determine scope of recourse
 - (a) Full liability
 - (b) Partial liability
 - (c) Construction completion guaranty -- but note, full payment out of collateral
 - (d) Covenant violations
 - (e) "Actual losses"
 - (f) Bad acts
 3. Guarantors
 4. Fix Liability in Foreclosure Action
 5. Calculation of deficiency
 - (a) Equal to amount of indebtedness less the greater of (i) successful bid in foreclosure or (ii) fair market value of the mortgaged property (generally based on appraisal)
 - (b) Contemporaneous (at time of auction) appraisal of mortgaged property (needed to determine deficiency)
 - (c) Consent judgment of foreclosure -- consent to deficiency calculation and to method for determining fair market value
 6. Short Statute of Limitations

VIII. Workout and Restructuring Strategies, Techniques and Objectives

- A. Pre-Workout Agreement/Standstill Agreement
 1. "Ticket for Admission" to Workout Discussions
 2. Preserves Status Quo
 3. Sets Ground Rules for Discussions
 4. Either Party can Terminate Discussions at any Time
 5. Protects Lender against Waiver, Oral Modification Arguments
 6. No Oral Agreements can be Made

7. Lender's Goal: Obtain Borrower's Acknowledgement of Debt and Waiver of Defenses (Difficult to Accomplish in a Pre-Workout Agreement)
 8. Loan Documents in Force
 9. Without Prejudice to Rights and Remedies
 10. Overreaching Admissions
 - (a) Fundamental fairness v. "ticket for admission"
 - (b) Duress
 - (c) Validity
- B. Background Considerations
1. Identify All Necessary Parties, Sources of Funding, Credit Enhancements
 2. Intercreditor Rights and Restrictions
 3. Identify, Negotiate and Resolve All Material Business Points Early to Avoid Borrower's Disguised Delay Tactics
 4. Engagement of Financial Consultants or Turnaround Specialists
 5. Beware Oral Modification or Waiver During Negotiations
 6. Prepare and Execute Detailed Term Sheet (Subject to Credit Approval)
 7. Issue a Loan Commitment, if Appropriate
 8. Need a Formal Instrument of Modification
 9. Need for Requisite Corporate or Partnership Authority
 10. Ratification of Loan Documents, Guaranties
 11. Consolidation of Debt and Mortgage (if New Advance)
 12. Obtain Subordination Agreements (or Discharge of Liens)
 13. Title Insurance -- Payment of Taxes

- C. To Avoid:
 - 1. Unrealistic Optimism about Borrower, Borrower's Business, the Property or the Market Place
 - 2. Needlessly Complex Strategies or Restructure Models
 - 3. Strategies that Ignore Essential Parties
 - 4. Strategies or Models where Lender has All Downside and Borrower has All Upside
- D. Opportunity for Enhancements
 - 1. Concessions or Contributions from Other Lenders
 - 2. Concessions or Contributions from Private Equity
 - 3. Additional Collateral (Shares of Stock, Partnership Interests, Business Assets, Homes, Reserve Accounts, Confessions of Judgment)
 - 4. Beware Pledge of Assets by Non-Obligors (Consideration, Fraudulent Conveyance Issues)
 - 5. New or Additional Guaranties -- Increasing Scope of Guaranteed Obligations
 - 6. Cure Legal or Document Deficiencies
 - 7. Obtain Additional Loan Covenants or Monitoring Rights
 - 8. Control of Project Revenue -- Cash Collateral -- Cash Management Agreement -- Lock Box
 - 9. Obtain Waiver and Release of Defenses and Counterclaims
 - 10. Ratification of Indebtedness
 - 11. Formal Extension of Matured Obligations
 - 12. Preserve or Improve Underlying Collateral (Capital Expenditures)
- E. Lender's Strategy -- Use of Workout to Fix Loan, Collateral and Perfection Defects
 - 1. Offer Concessions/Forbearance in Effort to Fix Collateral or Perfection Defects (Illustration -- Internal Audit Discloses U.C.C. Financing Statements Never Filed)
 - 2. Obtain Acknowledgement of Debt/Waiver of Defenses

3. Obtain Remedies -- Certainty, Finality, Predictability -- Finishes the Process
- F. Additional Collateral/Guaranties
1. As Consideration for Business Concessions by Lender
 2. Additional Collateral and/or Guaranties Protect Lender Against Downside, Further Business Erosion and Insolvency
 3. Expansion of Existing Limited Guaranties; Guaranty of Tranches of Debt
 4. Types:
 - (a) Partnership or membership interests
 - (b) Additional mortgages
 - (c) Other project interests
 - (d) Home mortgage
 - (e) Cash collateral
 - (f) Letter of credit
 - (g) Guaranties
 - (h) Confessions of judgment

IX. Alternative Restructure Models -- One Lender or Multi-Lender Transactions

- A. For Multi-Creditor Transactions:
1. Agency, Master Servicer, Special Servicer Considerations
 2. Default or Performing Loans
 3. Participant Suitability
 4. Major Decisions and Consent Rights
 - (a) Market standard
 - (b) Conflicts
 - (c) Enforcement of remedies
 5. Participant as "Squeaky Wheel" in Loan Restructurings
 - (a) Unanimous consent for certain major decisions (including loan extension and deferral of principal payments)
 - (b) Impact on other participants

- (c) Agent's responsibilities, alternatives and strategies
- 6. Open Business Discussion among Creditors
- 7. Awareness of Concessions, Contributions and Business Requirements by Other Creditors
- 8. *Pari Passu* Relationships
- 9. Treatment of Claw Back (Excess Cash Flow), Deferral Notes and Debt Forgiveness
- 10. Beware: Tortious Interference with Contract
- 11. Guaranty Dilution
- B. Reinstatement of Loan -- Cure Short Term Default
 - 1. Justification for Default
 - 2. Borrower's Open and Honest Reaction to Market Forces -- Catastrophic Loss, Product Change, Deferred Maintenance Obligations, Business Contraction
 - 3. Technicality -- Withdraw Acceleration (No Obligation to Do So)
- C. Discounted Repayment Agreement -- as an Exit Strategy
 - 1. Tied to Market Conditions, Lender's Business Objectives, Target Market
 - 2. Example -- \$50MM Debt -- Accept \$45MM in Six Months or \$40MM Immediately
 - 3. Include Remedies -- Discount Debt as an Incentive to Sell or Refinance Coupled with Consent Judgment of Foreclosure -- Ensure Finality
 - 4. In Non-Recourse Loan, Discount Needs to Give Borrower Incentive to Pay the Discount -- Possible Equity Recapture by Borrower
 - 5. In Recourse Loan -- Discount in Exchange for Release of Note and Guaranty
 - 6. Never Release Note or Guaranty Until Payment or Consensual Asset Liquidation has Occurred
- D. Short Term Forbearance Agreement
 - 1. Six Months to Cure Identified Business Problem -- Suspension or Reduction of Debt Service Payments
 - 2. Waiver of Covenant Defaults

3. Waiver of Defenses, Acknowledgement of Debt, Release of Claims
 4. Remedies
 - (a) Nature and extent
 - (b) Overreaching
 - (c) Duress
 - (d) Reaction of the courts
- E. Longer Forbearance (i.e., One to Two Years) Tied to
1. Shortening Maturity
 2. Economic Concessions
 3. Discounted Repayment Built into Restructure
 4. Remedies Included in Forbearance Agreement
 - (a) Consent judgment of foreclosure
 - (b) Confession of judgment
 - (c) Waiver of bankruptcy stay
 5. Additional Collateral Included in Forbearance Agreement
 6. Increasing Number of Guarantors or Scope of Guaranty
 7. Amplification of “Good Guy” Guaranty
 8. Accrual of Default Rate or Interest Shortfall, with Waiver upon Performance
- F. Substantive Loan Restructure
1. Restructure Loan to Conform to Market (Lower Interest Rates, Change or Eliminate Amortization, Less Burdensome Financial Covenants)
 2. Reduce Interest Rate or Principal Debt if Borrower Infuses Cash, Stabilizes Business, Brings in Beneficial Business Partner or Adds Collateral
 3. Principal Debt Repayment Plan with Contractual Incentives (e.g., \$10MM Loan -- Recast at \$9MM; Pay \$2MM, Forgive \$1MM)
 4. *Pari Passu* with Other Creditors
 5. The Claw Back (Cash Flow) Component
 - (a) Stabilizes business
 - (b) Reduces debt loan

- (c) Keeps component of debt alive as leverage, with realistic expectation of payments out of on-going business operations
 - (d) Tied realistically to borrower's ability to perform and economic viability
- 6. Incorporate Remedies
 - (a) Consent judgment of foreclosure
 - (b) Consent to asset turnover
 - (c) Waiver of bankruptcy stay
 - (d) Liquidation
 - (e) Guarantor's confession of judgment
- G. Note A/Note B/Note C as Workout Device
 1. Note A as the "Performing" Note
 - (a) Market interest rate
 - (b) Pay rate/note rate/accrual
 2. Note B as the "Claw-Back" Note
 - (a) Cash flow
 - (b) Lock box
 - (c) Reporting requirements
 3. Note C as the "Deferral" Note -- Parties' Intention is Ultimate (Not Immediate) Forgiveness
 4. Discount or Forgiveness Only after Primary Debt Repaid
 5. Note A at Market Value, Interest Rate and Business Capabilities
 6. Note B Tied to Cash Flow Formulas, Business Improvement
 7. Sharing Arrangements with Other Creditors
 8. Note B Guaranteed
 9. Note C as Leverage to Maximize Loan Restructure Performance
 10. Notes B and C Come Due upon Default
 11. Note A/B Structure in Lieu of Forbearance
 12. Claw-Back Tantamount to Cash Flow Mortgage

**X. Deed in Lieu -- Consent Judgment of Foreclosure --
Consensual Turnover or Liquidation of Assets**

- A. Implications and Benefits of Deed-in-Lieu
 1. Business Decision to Take Back or Market the Collateral
 2. Predictability
 3. Speed
 4. Finality
 5. Deed or Consensual Liquidation -- Faster than Court Remedies
 6. Need Consent Judgment to Wipe Out Subordinate Liens on Real Estate
 7. Lender Should Strive to Make the Remedy Part of the Workout
 8. Ramification of Consent Judgment of Foreclosure in Escrow
 9. Benefits of Entry of Judgment of Foreclosure with Stay of Execution
- B. Non-Delivery of Deed in Lieu of Foreclosure as “Bad Boy” Act
 1. In Some States (e.g., New York -- RPL Section 320) a Deed in Lieu of Foreclosure in Escrow is Considered “Additional Collateral Security in the Nature of a Mortgage.”
 2. Rather than Hold the Deed in Escrow, the Lender Should Require Borrower, upon the Occurrence of a Default, to Execute and Deliver the Deed to Lender or its Designee or Nominee.
 3. Failure to Perform this Covenant Constitutes a “Bad Boy” Act Triggering Full Recourse Under the Guaranty.
 4. If There Was No Creditworthy Guarantor at Loan Origination, a New Guaranty from a Creditworthy Party Could be Executed and Delivered as Part of the Restructure.

5. The New Guaranty Could Provide for Full and Unconditional Recourse upon Borrower's Failure to Deliver the Deed in Lieu of Foreclosure, As and When Required.

XI. Lender's Sale of the Distressed Loan to a Third Party

- A. Speed, Certainty, Finality, Elimination of Further Risk of Loss
 1. "First Loss is Best Loss"
 2. Lender's Capital Requirements
- B. Target Market Considerations -- "Leave" Relationships
- C. The Third Party Purchaser Bargains for Long Term Upside Value
- D. Public Relations upon Enforcement, Lender Liability Considerations
- E. Ready Marketplace -- Purchasers of Distressed Debt
 1. Exclusivity
 2. Due Diligence
 3. Seller Financing the Loan Purchase
- F. Lender Liability Considerations -- Tortious Interference with Prospective Contractual Advantage
- G. Split of Loan into Tranches and Sale of Parts
 1. Different Markets
 2. "Higher Risk -- Higher Rate"
 3. "Loan to Own"
- H. Proof of Original Note
- I. Loan Purchaser's Due Diligence
 1. Underlying Loan Documents -- Signatures
 2. Priority of Lien
 3. Scope of Guaranty
 4. Title Insurance
 5. Property Analysis
 6. Enforcement of Underlying Loan Documents
 - (a) Status of loan
 - (b) Nature and quality of default

- (c) Communications with borrower -- lender liability
- (d) Internal memos and communications -- admissions against interest
- (e) Foreclosure timeline and “judicial sympathy”
- (f) Leverage of guaranty -- “release of guaranty in exchange for deed”

XII. The “Hope Certificate”

- A. Applicable to Discounted Repayment or Sale of Debt Workout Models
- B. Prevents Borrower’s Quick or Premeditated Flip of Assets at a Profit
- C. Protects Lender in Soon-to-be-Rising or Uncertain Market
- D. The “Soft Note” Model
 - 1. Lender Retains a Portion of the Debt
 - 2. No Debt Service Payments
 - 3. Note Collateralized by Second Mortgage or Lien Without Foreclosure Remedies
 - 4. Intercreditor Agreement -- New First Mortgagee Consents to the “Soft Second” Lien
 - 5. Upon Quick Sale or Refinance, Lender Receives Additional Payment
- E. The Burn Away
 - 1. The “Hope Certificate” Burns Away After Negotiated Short Period (i.e., Six Months to One Year) or in Stages
 - 2. Prevents Premeditated Flip at a Profit
- F. Tool to Accomplish the Loan Sale