Mortgage Lending Roundtable – Guaranty Enforcement; Prepayment Premiums; Assignments of Loans by Lenders; Prohibited Transfers

by

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MORTGAGE LENDING ROUNDTABLE -- GUARANTY ENFORCEMENT; PREPAYMENT PREMIUMS; ASSIGNMENTS OF LOANS BY LENDERS; PROHIBITED TRANSFERS©

I. Overview of Guaranties and the Latest Trends in Guaranty Enforcement

A. Scope of guaranties

1. Promise to pay the obligations of another
2. Can be unconditional or limited (partial)
3. The guaranty as leverage for borrower's commitment to the property and to repayment
4. "Honor" isn't enough
5. Joint and several guarantors
6. Independent of obligations of borrower
7. "Stopping the clock" -- tender of deed v. completion of foreclosure v. negotiated middle ground
8. Guaranty "burn off" if benchmarks (or milestones), such as leasing, DSCR (debt yield tests) or capital infusion, are met
9. Doctrine of novation
10. Ratification of guaranties -- implications and waivers
11. Beware of conduct, or course of conduct, that releases guarantors
12. "Carveouts" as a negotiation device

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B. Type of guaranties

1. "Several" guaranty -- each guarantor covers a fixed portion of the debt (principal, or interest, or completion)
2. "Serial" or "subordinated" guaranty -- guarantor no. 2 responsible for deficiency after guarantor no. 1 doesn't pay
3. Partial payment guaranty
    a. Evaluate sufficiency in the context of a secured real estate loan (see deficiency rules below)
    b. Make sure guaranty covers last, not first, obligations
4. Construction completion guaranty
    a. Guarantor completes project at guarantor's expense or
    b. Lender completes project at guarantor's expense or
    c. Liquidated damages provision (negotiated "settlement" amount in lieu of actual undertaking to complete)
5. Full or partial debt service guaranty
6. Environmental indemnity or guaranty
7. Carry guaranty (real estate taxes, insurance premiums, other property-related expenses)
8. Guaranty covering obligation to replenish interest reserves
9. Financial (or other) covenants guaranty
10. Use of "bad boy" springing guaranties for "non-recourse" exceptions
    a. A "bad boy" guaranty provides for personal liability against principals of borrower upon the occurrence of certain enumerated "bad acts"
    b. Principal or affiliate would have no obligation to repay the loan (i.e., "non-recourse") unless there was some "bad" act
    c. This is a behavior modification (a "bad" act) -- not a credit enhancement

C. Common "bad boy" triggers ("non-recourse exceptions")

1. Fraud or misrepresentation
2. Diversion of cash flow -- misappropriation of rents or revenues
3. Environmental liability
4. Interference by borrower or guarantor with legal remedies
5. Material alteration of collateral
6. Waste (or mismanagement)
7. Filing bankruptcy (or soliciting an involuntary bankruptcy)
8. Modification of borrower's articles or organization
9. Violation of "SPE" (special purpose entity) or "separateness" covenants
10. Difference between "actual losses" and "entire debt" categories of recourse

D. Nature of "bad boy" guaranty of a "non-recourse" real estate loan

1. "Entire debt" bucket (liability for entire indebtedness)
    a. Voluntary bankruptcy
    b. Collusive involuntary bankruptcy commenced against borrower or guarantor
    c. Prohibited transfer of the mortgaged property
    d. Breach of the special purpose entity covenants
    e. Interference with mortgage foreclosure remedy
    f. Insolvency
2. The "actual losses" bucket (liability limited to lender's actual damages by virtue of the specific "bad act")
    a. Fraud or misrepresentation
    b. Misappropriation of revenue
    c. Misappropriation of condemnation awards or insurance proceeds

d. Failure to turn over income or revenues from the property during an event of default

e. Acceptance of more than one month's advance rent

f. Physical waste

g. Failure to pay real estate taxes or insurance premiums

h. Objection to non-judicial foreclosure, if applicable

E. 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"

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 -- $80 million loan; $100 million fair market value

(ii) At foreclosure -- $80 million loan; $50 million fair market value

(iii) $10 million partial guaranty

(iv) There will be a $30 million deficiency; ask the court for permission to sue guarantor for $10 million

(v) Cases support this practice though it is rare

3. 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

F. Deficiency judgment proceedings against guarantor

1. Determine scope of recourse

a. Full liability

b. Partial liability

c. Construction completion guaranty -- but note: if full payment is realized out of foreclosure or disposition of collateral, guarantor is released of obligation to complete

d. Covenant violations

e. "Actual losses" -- measure of proof

f. Bad acts -- determine if bad act triggers full recourse (see above)

2. Real estate guaranties are effectively "deficiency guaranties"

a. Invariably the lender looks to collateral first -- because real property cannot be secreted and election of remedies applies

b. Guarantor gets fair market value credit, under the New York rules

c. Guarantor named as defendant in foreclosure action (“one action”)

d. This is a lender concession in structuring the loan, though not really so in commercial real estate (because of election of remedies)

e. Establish liability for deficiency in phase II of the foreclosure action (deficiency judgment proceedings)

3. Calculation of deficiency

a. Equal to amount of indebtedness less the <u>greater of</u> (i) successful bid in foreclosure or (ii) fair market value of the mortgaged property (generally based on appraisal)

b. Hot Tip -- Contemporaneous (at time of auction) appraisal of mortgaged property is needed to determine the deficiency accurately

c. Hot Tip -- Consent judgment of foreclosure -- borrower and guarantor consent to deficiency calculation and to method for determining fair market value

G. 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. 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

(a) Put borrower in bankruptcy to trigger defaults

(b) Use threat of putting borrower in bankruptcy or triggering other default in negotiations with first lien lender

(c) Party in control of directing borrower’s actions should be responsible for guaranty in order for guaranty to be effective

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H. *ING v. Park Avenue Hotel* (610 Lexington Avenue)

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 $300,000 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 $145 million; fair market value was $55 million -- deficiency was $90 million
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. The outcome -- borrower "purchased" the loan at a discount (of $75 million)

I. *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

II. Latest Rulings on Prepayment Premiums

A. Background

1. The "Perfect Tender" rule
   a. Under the law, prepayment of a loan is <u>prohibited</u>
   b. <u>Unless</u>: The borrower negotiates for the right to prepay
   c. The theory: The lender is entitled to the economic value of the contract -- interest rates could go down -- and the lender has bargained for a contractual return over the life of the loan

d. A prepayment premium compensates the lender for the economic loss

(i) Yield maintenance

(ii) 5-4-3-2-1 (declining premium, each year of the loan)

e. Never call the prepayment premium a "penalty." (Penalties are not enforceable.)

B. Voluntary prepayment

1. What is "voluntary"?

a. Early payment -- payment prior to the maturity date

b. Acceleration -- borrower is compelled to pay the indebtedness in full in advance of the maturity date; that is not voluntary

c. In that acceleration "advances" the maturity date, a subsequent payment, by definition, is not a prepayment

2. There are two exceptions to this rule:

a. Intentional default

(i) An intentional default by borrower to avoid the premium (borrower cannot default, invite a loan acceleration and then state that the maturity date has been advanced so that prepayment premium [or prohibition] does not apply

b. Contract provision

(i) If the contract (the note) states that prepayment premium is due even if the indebtedness is accelerated

c. This seems straightforward -- and was, at least until the *Momentive Performance Materials* case

C. *Momentive Performance Materials*, 2015 WL2330761 (SDNY, May 5, 2015)

1. *Momentive* involved the right to redeem or repay bonds/notes early, provided the noteholders received "make whole" payments
2. The make whole (prepayment premium) payments here were $200 million
3. The court acknowledged the "perfect tender" rule and the exceptions identified above, saying they do not apply
4. In order to avoid a make whole payment, the parties' contract needs a "clear and unambiguous clause calling for payment of the prepayment premium"
5. The parties' contract did not cover the automatic acceleration of the note in bankruptcy
    a. The notes focused on voluntary prepayment (redemption) and the premium (make whole) that would be due -- leaving out acceleration by reason of bankruptcy
6. In this case, bankruptcy was not a tactical device to cause acceleration of the debt merely to deprive the lender of the make whole payment
7. The bankruptcy *ipso facto* caused the debt to become due without any declaration by the lender
    a. The maturity date was contractually advanced
    b. This was not a prepayment
    c. This was not elective or voluntary
8. The court held that the contract did not clearly and unambiguously cover acceleration by bankruptcy -- thus, the prepayment premium is not due
9. **The lesson learned:** The contract must provide that borrower must pay the prepayment premium <u>whenever</u> the debt is repaid prior to <u>the original maturity date</u>, even if the loan is accelerated (in bankruptcy or otherwise)

D. *Energy Future Holdings*, Case No. 14-10979 (Bankruptcy Court Delaware, March 26, 2015)

1. Here, too, the plain language of the contract did not require payment of a prepayment premium following acceleration arising from bankruptcy filing
2. Bankruptcy filing here was <u>not</u> an intentional default, contrary to the noteholders' assertion
3. There is a question of fact as to whether noteholders can waive the default and "decelerate" the notes after a bankruptcy!
4. *Energy Future Holdings* was running out of cash; the noteholders say it was intentional (to avoid the prepayment premium)
5. The court holds --
   a. Contract is not ambiguous
   b. The plain language -- no prepayment premium is due
   c. Contract does not say "prepayment premium is due upon acceleration"
6. Under New York law:
   a. a borrower's payment after acceleration is not voluntary
   b. acceleration advances the maturity date to the date of acceleration
   c. The debt has "matured"
7. Under New York law -- citing cases:
   a. There must be express language for payment of a prepayment premium upon acceleration
   b. The court is unwilling to read in a provision that is not there
8. Ruling -- because the language does not specify the prepayment premium is due, it is not due

9. Fact that bankruptcy was used to avoid prepayment (as a benefit of the bankruptcy) does not mean this was intentional or voluntary

    a. Here: overwhelming evidence of severe liquidity crisis

    b. There was no evidence that Energy Future Holdings refused to sell its subsidiary for $18 billion to avoid a $400 million prepayment premium

10. Debtors (borrowers) can use the tools of bankruptcy (like the power to reject leases) for business reasons

III. Assignments of Loans by Lenders

A. The lender's objective:

1. The lender wants the right to assign or transfer the loan or interests in the loan, freely

2. The theory: if the borrower performs and repays the loan -- why should the identity of the lender (the holder of the debt) matter

B. Borrower has three concerns

1. "Loan to own" lenders

    a. A "shadow lender," for example, looks for a borrower default in order to foreclose, impose default interest, profit upon acceleration, and/or own the collateral

    b. "Shadow Lenders": Opportunity funds; distressed debt purchasers; private equity investors; competitors

    c. Entire portfolios on market

2. For construction loans --

    a. Borrower needs to know construction advances will be made upon requisition

    b. Borrower carefully picks the loan syndicate at origination -- it bargains for the reliability of "future" advances

c. The sponsor does not want its project at the whim of a “credit committee” in Asia

3. Competitors

a. Developers and sponsors do not want to disclose to competitors:

(i) Their financial information

(ii) Business operations

(iii) Leasing or capital improvements programs

(iv) Tenant rosters and the like

b. Cannot emphasize enough the industry paranoia -- “secret sauce”

C. How to deal with this -- parties negotiate “eligible assignees”

1. This is an art

2. Leverage of parties to the deal

3. What have they done on previous deals

4. How important to lender/if never planning on syndicating

D. Types of eligible assignees

1. Commercial, savings, investment banks

2. Pension funds having greater than $5 billion in assets

3. Reputable institutional investors making similar loans

4. Non-defaulting co-lenders

E. The carve out -- “prohibited persons”

1. Provided the borrower is not in default, the lender cannot sell to a negotiated list of “prohibited assignees”

2. The parties negotiate “short lists” and “long lists” depending on deal leverage, past practice and their relationship

F. If borrower is in default all bets are off . . . Or are they : “prohibited assignee period“

1. First 30 days after event of default there are certain non-eligible assignees

2. After 90 days (after default) the lender can sell or assign to anyone including prohibited persons

3. And what type of default: Material? DeMinimus? Any?

IV. "Prohibited Transfers" of Interests in Borrower

A. Lender's initial position:

1. No transfer of interests in the borrower (or the mortgaged property) permitted without lender consent

B. Exceptions:

1. Provided the transfer does not change control, no consent required for:

   a. A transfer of up to 49% interest, provided borrower and its principals continue to own 51% and remain in control and borrower is not in default

   b. Lender must be satisfied with Patriot Act and KYC searches of any entity acquiring 20 or more percent

C. Replacement guaranty:

1. If there is a transfer of more than 49% and lender consents, there shall be a replacement guarantor

2. Creditworthiness must be acceptable to lender

D. **Prohibited persons for the replacement guaranty:**

1. In default to any lender (or administrative agent)

2. Subject of a workout with administrative agent or any lender

3. In litigation with administrative agent or any lender (plaintiff or defendant)

4. Subject of bankruptcy

5. Indicted or convicted of felony, moral turpitude, Patriot Act

6. Embargoed persons (International Emergency Economic Powers Act, Trading with the Enemy Act)

A POSTSCRIPT --

SCRIVENER'S LESSON LEARNED:

BEWARE THE INADVERTENT RELEASE OF COLLATERAL DURING LOAN ADMINISTRATION --

(*Official Committee of Unsecured Creditors of Motors Liquidation v. JPMorgan Chase Bank*, 13-2187, 2d Cir., January 21, 2015)

A. The Facts

1. $300 million synthetic lease made in 2001 secured by liens on twelve real properties
2. In 2006 JPM makes a $1.5 billion term loan to General Motors secured by:
    a. A lien on equipment and fixtures at 42 locations
    b. 28 UCC-1's filed around the country
    c. A primary UCC-1 filed in Delaware
3. In 2008 GM's counsel prepares documents to release the liens for the $300 million synthetic lease
4. A paralegal's search discloses three UCC Financing Statements – two for the synthetic lease and one for the $1.5 billion term loan
5. The paralegal prepares UCC-3 Termination Statements terminating all three security interests
6. No one noticed this error
7. JPM's counsel approves the filing of the UCC-3 termination statements
8. All three UCC termination statements are filed and all collateral is released
9. In GM's bankruptcy, the Committee of Unsecured Creditors sought a determination that all UCC-3 termination statements were effective
10. JPM said the termination, as respects the $1.5 billion term loan, was not authorized

B. Bankruptcy Court Ruling

1. The bankruptcy court held that none of the parties (i.e., "mutual mistake") intended the collateral for the $1.5 billion term loan to be released
2. In that the collateral releases were not intended, they were not authorized, and they were not binding

C. Delaware Supreme Court Reverses

1. The Delaware Supreme Court held that if the termination statements were authorized for filing, the parties' intent does not come into play
2. This is the case even if there is "mutual mistake" and the parties stipulate they did not authorize the release of lien
3. Before a secured party authorizes the filing of a termination of its security interest, it "ought to review and understand" the implications

D. The Second Circuit Affirms

1. The court acknowledged that the secured party must authorize the release of its collateral
2. Did JPM do so?
3. JPM said it never instructed its counsel to file the release of collateral covering a $1.5 billion term loan; rather, the instruction was limited only to the collateral for the synthetic lease
4. The Court disagreed
5. Copies of the draft termination statements were sent to JPM and its counsel for review. Upon such review, counsel said: "nice job on the documents"
6. JPM expressly authorized the release of the termination statements from escrow
7. According to the Court, the loan officer had actual authority to file the release, and actually authorized such release. "Nothing more is needed."

E. The Lesson Learned

1. The sanctity of the recording statutes governs. Third parties have the right to rely on matters of record. If a security interest has been terminated, the impact is binding on the secured party and all prospective new lenders can rely thereon

2. As in carpentry, “measure twice and cut once.”

F. An Update

1. Class action lawsuits on behalf of more than four hundred lenders against JPM and its counsel were voluntarily dismissed on October 30, 2015