REAL ESTATE LOAN WORKOUTS AND REMEDIES -- RULES, STRATEGIES AND LATEST INSIGHTS©

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I. Understanding the Relevant Market

1. Availability of financing
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1. No downside risk for borrower
2. Borrower has all upside of delay, assertion of defenses, bankruptcy filing
3. Is there a benefit to borrower's continued management and ownership

L. Mezzanine Lender's Rights

1. Intercreditor agreement governs use of remedies
2. Negotiation of "market" intercreditor agreement
3. No lien on real estate
4. Succeed to borrower's interests -- control of project
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3. Notice to tenants
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6. Lock box arrangement -- joint notice to tenants
7. Protecting and preserving collateral during and after entry of judgment of foreclosure; statutory requirements resulting from economic downturn

II. 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

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
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. Construction Completion Guaranty

1. There are three primary options --
   (a) Guarantor completes at guarantor's cost (lenders virtually never invoke this)
   (b) Lender completes the project and guarantor pays costs of completion
   (c) Guarantor pays liquidated damages -- difference between costs remaining to complete and balance of loan undisbursed (this one is typically used)
   (d) Illustration of liquidated damages:
      (i) $37 million loan
      (ii) $20 million disbursed
      (iii) $17 million undisbursed

(iv) Cost to complete = $25 million

(v) Cost to complete ($25 million) minus balance of loan undisbursed ($17 million) = $8 million liquidated damages

2. Alternative -- cap each guarantor's amount of guaranty

(a) Fixed dollars or percentage of total liability

3. Alternative -- completion reserve established by borrower (unrealistic)

4. Election of remedies (the legal principle -- either foreclose the mortgage or sue on the note/guaranty, but not both at the same time [see below] -- does not apply)

5. Lender cannot profit --

(a) Illustration: debt is $10 million and fair market value of collateral is greater than $10 million

(b) Lender is made whole on foreclosure

(c) Lender cannot hold guarantor responsible for completion (that would be a windfall)

6. Subject to "the windfall defense," guarantor shall be liable to pay liquidated damages re**g**ardless of whether or not lender intends to complete or actually completes the project

7. Guarantor's liability to pay liquidated damages shall survive foreclosure or other disposition of the property

8. If lender acquires the property in foreclosure, and the higher of the "credit bid" or fair market value is less than the debt, then guarantor's liability shall not be released

D. Common "Bad Boy" or "Springing Recourse" Triggers ("Non-Recourse Exceptions")

1. Fraud or misrepresentation

2. Diversion of cash flow -- misappropriation of rents or revenues

3. Interference by borrower or guarantor with legal remedies

4. Material alteration of collateral

5. Waste (or mismanagement)

6. Filing bankruptcy (or soliciting an involuntary bankruptcy)

7. Modification of borrower's articles or organization

8. Violation of "SPE" (special purpose entity) or "separateness" covenants
9. Difference between "actual losses" and "entire debt" categories of recourse (see below)

E. Nature of "Bad Boy" (or "Springing Recourse") Guaranty of a "Non-Recourse" Real Estate Loan

1. "Entire debt" bucket (liability for entire indebtedness)
   - (a) Voluntary bankruptcy
   - (b) 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
   - (g) Tailored deal specific "entire debt" triggers
2. The "actual losses" bucket (liability limited to lender's actual damages
   - (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
   - (i) Gross negligence or willful misconduct
3. Use of springing recourse in workouts (see discussion below)
   - (a) Failure to deliver deed in lieu of foreclosure
   - (b) Failure to execute contracts
   - (c) Failure to deliver possession of mortgaged property

F. 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)

(d) Doctrine does not apply to mortgaged property located outside New York

(e) Doctrine only applies to an action to recover the mortgage debt (not to completion guaranties)

2. Hot tip in New York -- "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 -- $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

3. Cases support this practice though it is rare -- 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

G. 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

4. Short Statute of Limitations

H. Guarantor Covenants

1. Guarantor shall not, without lender's consent, transfer assets without receiving fair market value for such transfer

2. Financial covenants

(a) Guarantor shall (if more than one, on a combined basis) maintain "unencumbered liquidity" of not less than a certain dollar amount (e.g., $5 million) (a "liquidity standard")

(b) "Unencumbered liquidity" is defined as unrestricted investments (cash, cash equivalents, marketable securities) not used as collateral for any other obligation

(c) Guarantor (if more than one, on a combined basis) shall maintain a minimum net worth of not less than a certain dollar amount (e.g., $100 million)

(d) "Net worth" is defined as the excess of aggregate total assets over aggregate total liabilities

(e) Guarantor (if more than one, on a combined basis) shall maintain recurring cash flow of not less than a certain dollar amount (e.g., $5 million)

3. Guarantor shall furnish within 120 days after each calendar year updated personal financial statements prepared by a certified public accountant

4. Guarantor shall furnish copies of federal and state tax returns concurrently with the filing thereof

5. During an event of default, lender has the right, at guarantor's expense, to audit guarantor's financial statements

6. Guarantor shall furnish such other documents and assurances as lender shall require

I. Bad Boy Guaranties are Enforceable

1. Reported decisions in favor of lender

(a) *Bank of America, N.A. v. Lightstone Holdings, LLC*, Index No. 601853/09, 2011 NY Slip Op 51702(U) (Sup. Ct. N.Y. Co. 2011)

(b) *G3-Purves Street v. Thomas Purves*, 101 A.D.3d 37 (2d Dep't 2012)

(c) *172 Madison (N.Y.) LLC v. NMP-Group, LLC*, 650087

(d) *USB Commercial Mortgage Trust -- FLI v. Garrison Special Opportunities Fund L.P.*, 2011 WL 4552404 (N.Y. Sup. Ct. 2013)

(e) *Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. Partnership*, 812 N.W. 2d 799 (Mich. Ct. App. 2011)

(f) *Cherryland II*, 493 Mich. 859 (2012)

(g) *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC*, 835 F.Supp. 2d 384 (E.D. Mich. 2011)

(h) *Bank of America N.A. v. Freed*, 983 N.E. 2d 509 (Ill. App. Ct. 2012)

(i) *Wells Fargo Bank N.A. v. Mitchell's Park*, 10-CV-3820 (N.D. Ga. 2012)

(j) *Steven Weinreb v. Fannie Mae, 993 N.E.2d 223 (2013)*

(k) *Turnberry Residential Ltd. Partner v. Wilmington Trust*, 2012 NY Slip Op 06050, August 28, 2012

(l) *LaSalle Bank v. Pace* (Sup. Ct. N.Y. Co., 15822-08, Feb. 28, 2011)

(m) *J.E. Robert v. Signature Properties, LLC*, 2010 WL 796774 (Conn. Super. Ct. 2010)

(n) *Blue Hills Office Park v. JPMorgan Chase Bank*, 477 F. Supp. 2d 366 (D. Mass. 2007)

(o) *CSFB 2001-CP-4 Princeton Park Corporate Center v. SB Rental I*, 410 N.J. Super. 114, 980 A.2d 1(App. Div. 2009)

(p) *Wertheimer Mall* -- 2008 U.S. Dist LEXIS 64152 (SDNY 2008)

(q) *111 Debt Acq. v. 6 Venture*, 2009 U.S. Dist. LEXIS 11851 (E.D. Ohio 2009)

(r) *Diamond Pt. v. Wells Fargo*, 929 A.2d 932 (Md. 2007)

(s) *Potomac v. Green*, 2099 WL 1537853 (M.D. Ala. 2009)

(t) *Heller Financial, Inc. v. Lee*, 2002 WL 1888591 (N.D. Ill. 2002)

(u) *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

3. 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)] (Sup. Ct. N.Y. Co. 2010)

(b) Rule -- mezzanine lender must cure defaults (including full payment upon acceleration or maturity) under first mortgage loan before pursuing remedies

J. ***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 $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. Post Script -- borrower "purchased" the loan at a discount (of $75 million)

K. ***CP III Rincon Towers v. Cohen*****, 10 Civ. 4638 (S.D.N.Y. 2014), rev'd, 666 Fed.Appx. 46 (2d Cir. 2016)**

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 District 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. Second Circuit reversed
8. Question of fact as to intended language in contract; guaranty is ambiguous and extrinsic evidence needed to determine whether liens triggered full recourse

L. Other Cases "Pro-Guarantor"

1. *GECCMC 2005-C1 Plummer Street Office Ltd. Partnership v. NFCNNN Holdings, LLC*, 204 Cal. Rptr. 3d 251 (Cal. Ct. App. 2012)
2. *Wells Fargo Bank v. Palm Beach Mall, LLC*, 2013 WL 6511651 (Fla. Cir. Ct. 2013), aff'd, 177 So. 3d 37 (Fla 4th Dist. 2015)

III. Analysis of Clogging the Equity of Redemption -- Dual Collateral Loans

A. Background

1. Lender has first mortgage on borrower's real property
2. Lender takes a pledge of borrower's members' membership interests in borrower entity as additional (dual) collateral for the same loan (not as a separate mezzanine loan to a separate borrower)
3. Lender can foreclose the membership interests non-judicially (expediently) under the Uniform Commercial Code
4. Pledgor of the dual collateral acquiesces in the structure as a condition to the loan; i.e., the loan proceeds would not otherwise be available for the subject project (or the cost of the loan would be substantially higher)

B. Clogging is Impermissible

1. Courts protect borrower's rights against overreaching or unscrupulous lenders
2. "Once a mortgage always a mortgage"
3. Property owner's right to redeem the property from the lien of the mortgage is a sacrosanct principle of real estate finance
4. "Dual collateral loan" -- akin to an option to purchase (credit bid) on default
5. Two years to foreclose (in New York) v. two to four weeks to redeem in the non-judicial setting applicable to the membership pledge
6. Pledge membership interests -- U.C.C. foreclosure via public or private sale -- transfer as early as 10 days -- "Commercial Reasonableness"
7. Sophistication of borrower should not matter -- transfer in lieu upon default is antithetical to the concept of a mortgage because it removes the right to redeem
8. Deed in lieu -- direct conveyance or delivery of deed into escrow unenforceably clogs equity of redemption (RPL Section 320) -- deed in escrow is additional collateral in nature of mortgage
9. Removal of deed from escrow "robs" borrower of equity
10. No opportunity to find replacement financing or buyer to preserve equity -- impossibility of performance as a compelling defense
11. "Equity Abhors Forfeiture"
12. See *Goldblatt v. Iris Construction*, 28 Misc. 2d 621 (Sup. Ct. 1960)
13. See *Gioia v. Gioia* (escrow) 234 A.D.2d 588 (1996)
14. See the rules applicable to convertible mortgages under General Obligations Law 5-334 -- option to purchase at future date is fine; if option is triggered by borrower's default, not fine -- becomes additional security -- otherwise gives lender the right to circumvent recognized foreclosure proceedings and timeline
15. Institutional lenders typically do not take dual collateral in the nature of an equity pledge (thought this may be changing)

C. The Contrary View -- Taking the Mortgage and the Pledge of Equity is Not a Clog

1. Pledge of equity interests is not a deed in escrow
2. Pledges of personal property collateral are lawful and recognized by statute (U.C.C. Section 9-623)
3. Pledge of membership interests are personal property, not real property
4. Borrower retains the right to redeem -- at or prior to public auction -- borrower (or interested party) can bid -- there is a statutorily mandated auction process
5. Performance (redemption) is not rendered impossible
6. The pledge is given by a sophisticated party, at arms' length, in exchange for a commercial loan; borrower's remedy -- repay that loan at any time prior to completion of U.C.C. foreclosure
7. Lender should be entitled to the benefit of its bargain and its remedies
8. Recent caselaw (see below)

D. *HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC* (Sup. Ct. N.Y.Co. June 20, 2018; Index No. 652871/18)

1. Plaintiff seeks to enjoin U.C.C. sale of partnership interests pledged as additional collateral for mortgage loan
2. Court denies injunctive relief and focuses primarily on the standards for a preliminary injunction (irreparable harm, adequacy of monetary damages, likelihood of success on the merits)
3. Court holds that any damages suffered by plaintiff by reason of loss of its real estate investment is compensable in monetary damages
4. Court also holds the equitable right of redemption has not been clogged
5. According to the Court: "Plaintiffs, at this very moment, retain a right of redemption under U.C.C. § 9-623, which provides that redemption may occur at any time before a secured party disposes of the collateral at a foreclosure sale. Thus, the U.C.C. provides a right of redemption if plaintiffs can fulfill their obligations under the applicable agreements."

6. Court also observes: "There is nothing to prevent plaintiffs from taking part in the bidding process at the U.C.C. sale."

IV. 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 that affects borrower's ability to perform financial obligations
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
13. Default under subordinate loan

B. De Minimus Defaults

1. Failure to deliver financial statements (timely, at all)
2. Breach of loan-to-value covenant
3. Entry of minor monetary judgment
4. Death of guarantor that does not impact management or control of mortgaged property
5. Erosion of cash flow
6. Material adverse change in financial condition
7. Cross-default under other credit facilities
8. Short term capital requirements

C. Evaluation of Efficacy of Material Adverse Change Covenant in this Economic Cycle

1. Permanence of "MAC"
2. Durational requirements -- "durationally significant"
3. Implication for loans that are otherwise performing

D. Grounds for Acceleration

1. Strict adherence to loan documents
2. "Less is more" – no need for litany of defaults -- rely on the most material default (or defaults)

E. Election to Accelerate

F. Notice of Acceleration

1. Clear
2. Overt
3. Unequivocal

G. 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
3. Entire debt is due -- acceleration as maturity

H. Return of Subsequent Debt Service Payments

1. Judicial sympathy
2. Borrower's intent in making tender
3. Use of pre-workout agreement to capture post-acceleration payments without waiver or prejudice

I. 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
3. Detrimental reliance
4. Judicial sympathy

V. 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
7. Implications on loan purchasers -- loan seller's obligation (if any) to cooperate in enforcement proceedings

8. New lender "inherits" the loan files, the course of dealing and the facts

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
   (a) Real estate taxes
   (b) Insurance
   (c) Essential repairs
6. Appraisal of property
7. Right to inspect collateral
8. Right to approve budgets (as part of restructure)
9. Right to receive release prices for existing or new collateral
10. Suggestions regarding sponsor or shareholder default

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 (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
   (b) Interference with valid contract or "prospective contractual advantage"
   (c) Defense of "justification"
   (d) Malice required for interference with prospective contractual advantage
5. Interference with valid contract or "prospective contractual advantage"
   (a) Overtures from disappointed prospective purchasers of the mortgaged property
   (b) Defense of "justification"
   (c) 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 realities in the marketplace and implications on occupancy and cash flow

I. Suitability of Participants as Lenders

1. Major decisions
2. Voting and control
3. "Veto power" and the doctrine of reasonableness

VI. 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
       - a) Non-payment of debt
       - b) Insurance -- casualty, terrorism issues/ requirements
       - c) Real estate taxes
       - d) Damage to property
       - e) Failure to maintain property
       - f) Subordinate financing
       - g) Transfer of property
       - h) Environmental violation
       - i) Non-delivery of financial statements
       - j) Monetary judgment

k) Material adverse change in financial condition

(ii) Right to accelerate

(iii) Right to foreclose

(iv) Entire debt secured by mortgage

(v) Receivership -- without notice and without regard to the adequacy of the collateral security; examine loan provisions carefully (appointment of receiver "upon default")

(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. Analysis of Real Estate Mortgage Loan Administration after Closing and Prior to Acceleration

1. Closing checklist compliance
   (a) Actual recordation of the mortgage
   (b) U.C.C. filings
   (c) Title insurance policy
   (d) Property insurance policy naming mortgagee
2. Periodic title updates and insurance

C. 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

D. 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

E. 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

(i) Compare “indispensable,” “necessary” and “permissible” parties defendant

4. Election not to foreclose anchor or market tenants -- implications on leasehold obligations

5. Subordination and non-disturbance agreements

F. 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. Separate cause of action against “bad boy” guarantor even if springing recourse has not been triggered prior to commencement of foreclosure action (triggering event -- i.e., bankruptcy -- may occur during pendency of foreclosure)

10. Update the foreclosure search

11. Multiple parcels – multiple counties – use of multiple notices of pendency

G. 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

H. 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 (opportunistic purchasers with notice of the foreclosure)
5. Sale of the loan
6. Title insurance
7. "New debtor" and "new debtor syndrome"

I. Real Estate Tax Delinquency, Insurance, and Threats to Security and Priority of the Mortgage -- Catastrophic Loss -- Crisis Management

J. Summary Compendium of Foreclosure Defenses and Lender Liability Theories of Recovery

1. Classic lender liability
   - (a) Oral modification
   - (b) Waiver and estoppel regarding enforcement of remedies
   - (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 – change in borrower's position or economics (such as admission of new equity partner) based on loan modification or extension assurances from lender
   - (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) "Judicial sympathy" yields "judicial scrutiny"

(b) Proof of ownership of note

(c) Standing to sue

(d) "Robo signing" affidavits

(e) "Robo verifying" of facts, statements of debt and/or defaults

(f) Cutting corners in foreclosure process -- fraud

(g) Affiant's lack of personal knowledge of statements of debt and/or defaults in complaint or in summary judgment affidavits

(h) Defective foreclosures

(i) (Non)-enforcement of an allonge attached to a note by a paper clip -- applicability of U.C.C. 3-202 (*HSBC Bank USA, N.A. v. Roumiantseva*, 2015 NY Slip Op 06315, Appellate Division, 2nd Dept., July 29, 2015)

(j) Unsuitability of borrower for amount of debt; insufficient cash flow to service the loan and lender's knowledge thereof

(k) Change in underwriting standards and lender's affirmative duty to inquire as to borrower's finances

(l) Loan participant suitability

(m) Chain of title defenses -- *Ibanez*

(n) Impossibility of performance

(o) Force majeure

(p) Doctrine of "deepening insolvency" -- fraudulent expansion of corporate life

(q) "Loan to own" activities

K. Statute of Limitations as a Bar to Mortgage Foreclosure

1. *U. S. Bank National Association v. Parisi-Viola*, Supreme Court, Suffolk County, October 14, 2015 (Six year statute of limitations expired -- "The record before this Court does not show that plaintiff undertook any

affirmative act to revoke its election to accelerate the mortgage loan.")

2. *Ellery Beaver LLC v. HSBC Bank USA*, Supreme Court, Kings County, October 22, 2015 (The commencement of the first action on May 4, 2006 accelerated the entire indebtedness; any attempt to foreclose the mortgage -- in a second action -- was time barred after May 4, 2012.)

L. Champerty -- *Justinian Capital v. West LB*, 28 N.Y.3d 160

1. §489 NY Judiciary Law -- champerty where purpose is collection of a claim that would not otherwise be pursued; cannot acquire a loan or a claim for the sole purpose of suing on it
2. If one of several purposes, not champertous
3. Safe harbor in New York -- if the loan is purchased for more than $500,000 it is not champertous
4. Encourages trading of debt/commerce; New York has vibrant secondary debt trading markets
5. In Justinian, $209 million of notes were purchased for $1 million ($500,000 per loan)
6. Assignment of notes not contingent on payment of purchase price
7. Analysis
   (a) Simply intending to sue is not champerty but
   (b) Purchase for "very purpose" of suing is champerty
   (c) Purpose is critical -- to sue/not to get benefits of a deal -- "THE" purpose, not "A" purpose
8. No safe harbor here --
   (a) If payment is entirely contingent on successful outcome in litigation, it does not constitute a binding and bona fide debt (must be obligated to pay irrespective of outcome)
   (b) Purchaser needs "skin in game"

M. 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)
7. "Robo signing"
8. "Robo verifying"
9. Chain of title defenses

N. Second Mortgagee'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

O. 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

P. 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

Q. Receivership

1. Procedures, effectiveness and strategy in seeking appointment
2. Special rules for 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

R. 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

S. 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

T. Assignment of Bid

1. Prior to closing
2. Tax advantages
3. Non-ownership advantages
4. Disadvantages -- ownership "limbo"
5. Continuance of receivership

VII. Workout and Restructuring Strategies, Techniques and Objectives

A. Pre-Workout 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. Borrower's response: "lender alleges" the debt (rather than "borrower acknowledges" the debt)
9. Loan documents in force and effect
10. Discussions are without prejudice to rights and remedies
11. 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, mezzanine lenders
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 or restructuring 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 in Favor of Lender

1. Concessions or contributions from other lenders
2. Capital contributions from investors, private equity infusion
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, including "springing recourse" events
6. Cure legal, document or perfection 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. Obtain general release
11. Ratification of indebtedness
12. Formal extension of matured obligations
13. 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) (illustration -- ratification of guaranties; execution of loan documents)
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

G. Exchange of Concessions in Favor of Borrower or Guarantor

1. Extension of maturity date, i.e., "time"
2. Forbearance of enforcement of remedies
3. Debt modification (i.e., lower interest rate; note rate/pay rate models)

4. Release of collateral (or determination of release prices if multiple collateral)
5. Release of guarantors
6. Debt forgiveness – discounted repayment
7. Waiver or modification of covenants or financial reporting requirements

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

A. For Multi-Creditor Transactions:

1. Agency, master servicer, special servicer considerations
2. "Special servicer paralysis"
   (a) Market's reaction
   (b) Intentional defaults to compel loan modification
   (c) Anticipatory loan covenants and requirements
3. Default or performing loans
4. Participant suitability
5. Major decisions and consent rights
   (a) Market standard
   (b) Conflicts
   (c) Enforcement of remedies
6. Participant or syndicate member 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
7. Open business discussion among creditors
8. Awareness of concessions, contributions and business requirements by other creditors
9. *Pari passu* relationships
10. Treatment of claw back (excess cash flow), deferral notes and debt forgiveness
11. Beware: tortious interference with contract
12. 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 -- $100 million debt -- accept $90 million in six months or $80 million immediately
3. Include remedies -- discounted 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 or Standstill Agreement

1. Six months to cure identified business problem -- suspension or reduction of debt service payments
2. Waiver of covenant defaults
3. Modification of covenants or economic terms tied to market or asset performance
4. Waiver of defenses, acknowledgement of debt, release of claims
5. 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) Consent to vacate automatic stay in bankruptcy

(d) Consent to receiver or third party property manager

5. Additional collateral included in forbearance agreement

6. Increasing number of guarantors or scope of guaranty

7. Amplification of "bad boy" 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., $10 million loan -- recast at $9 million; pay $2 million, forgive $1 million)

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, anticipated market improvements (including leasing activities)
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

IX. Overview of Forbearance Agreements for 2019 and Beyond

A. Acknowledgement of Debt

1. Without defense, offset or counterclaim
2. Entire indebtedness -- including protective advances, default interest, prepayment premiums
3. Borrower and guarantor should acknowledge (even if limited or “bad boy” guaranty)

B. Ratification of Loan Documents

1. Borrower and guarantor obligated to perform
2. Validity
3. Binding effect
4. Perfection
5. Cure perfection/signature defects
6. Ratification brings these obligations forward

C. Forbearance Expiration Date

1. Provided borrower performs, lender will forbear enforcement of its remedies
2. Rather than waive defaults
3. Extension of forbearance expiration date can be built into agreement

4. Milestones and performance hurdles for forbearance or extension of forbearance

D. Payment Modification

1. Interest
2. Note rate/pay rate
3. Accrue default rate
4. Release default rate accrual upon full performance (i.e., payment)
5. Note A/Note B/Note C --

   Note A -- $80MM -- negotiated interest rate

   Note B -- $10MM -- interest tied to excess cash flow

   Note C -- $10MM -- deferred obligations

E. Discounted Repayment Option

1. Tie to Note A (see above)
2. Forgive discount at end
3. Motivates finality

F. Waiver of Defenses and General Release

1. Lender wants litigation certainty
2. Exchange of concessions
3. Contrast pre-workout agreement
4. Lender bargains for a clean slate
5. Duration of forbearance plays a role (contrast six month forbearance with two week forbearance)

G. Additional Collateral

1. Other (real and/or personal) property
2. Equity (membership) interests
3. Additional guarantor
4. Enhanced guaranties or scope of recourse
5. Performance/completion/bad boy protections
6. Interference with remedy triggers “bad boy” recourse
7. Lock box -- cash collateral
8. Consensual property manager

H. Remedies

1. Consent to judgment of foreclosure
2. Confession of judgment from guarantor
3. Consent to vacate automatic stay in bankruptcy

4. Promise to deliver a deed in lieu of foreclosure on a date certain, coupled with springing guaranty tied to non-performance of the promise
5. Consensual receiver/property manager
6. Lock box/control cash

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

A. Implications and Benefits of Deed-in-Lieu of Foreclosure

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. Deed in Lieu Strategies -- Non-Delivery of Deed in Lieu of Foreclosure as "Bad Boy" Act

1. In 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. Borrower's promise collateralized by the bad boy guaranty -- 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 -- Standing to Sue

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**

HIGH VOLATILITY COMMERCIAL REAL ESTATE -- OVERVIEW OF ORIGINAL REGULATIONS AND NEW STATUTE

I. Original High Volatility Commercial Real Estate ("HVCRE") Regulations (effective January 1, 2015) (C.F.R. 12 Section 324.2)

A. Under Basel III, Federal Regulatory Agencies Imposed New Risk-Based Capital Reserve Requirements:

1. Banks must assign certain additional risk reserves to certain commercial real estate acquisition, development and/or construction loans.
2. Any loan that is deemed to be a "high-volatility commercial real estate exposure" triggers the additional capital requirements (see "Risk Weight Penalty" below).

B. Scope of HVCRE Loans: All Acquisition, Development and Construction Loans (Which Are Considered Higher Risk Loans) Other Than Those Falling Into the Exemptions Listed Below.

C. Exemptions:

1. 1-4 unit family residential property
2. Community development investment
3. Agricultural land
4. Projects with:
   (a) Loan-to-value ratio less than 80% and
   (b) Borrower must contribute cash or capital of at least 15% of the "appraised as completed" value (not merely the project's "cost" but its "as completed" value) *prior to any loan advances*; and
   (c) Borrower *must keep its 15% equity invested in the project* until the loan is repaid in full.

D. Risk Weight "Penalty"

1. If the foregoing criteria are not met, the lender must assign a "150 risk weight" to the loan.
2. As an illustration, a $100 million HVCRE loan counts as $150 million towards the lender's risk weight.
3. By contrast, for multi-family loans (a very secure asset class), the lender must assign only a "50 risk weight" to the loan ($50 million on a $100 million loan).

E. The 15% Equity Exemption is Disallowed if the Governing Loan Documents Provide that Borrower May Distribute Any Cash (Such as Rent; Hotel Room Receipts) "Internally Generated" by the Project.

F. Observation:

1. Prohibiting distributions over the life of the loan to retain the HVCRE exemption is an overly harsh, and perhaps unintended, consequence.
2. This would equate the contractual term of a construction loan to the period of development risk, which is not the case typical in construction loans.
3. Previously, it was common for construction loan documents to provide for banks to confirm project performance, determine that development risk had passed and the project had stabilized, upgrade the risk rating and allow distributions to be made to investors as a return on their investment.

G. Non-Recognition of Appreciated Property Values

1. Previously, in order for a developer to satisfy the construction lender's own (case-by-case) "equity requirement," the borrower needed to have a sufficient equity interest in the property.
2. Property appreciation could, and did, apply.
3. If, for example, borrower paid $3 million for land many years ago but the land is now worth $15 million, borrower's equity in the appreciated value of the property would be considered by the lender, and would likely suffice as a "cash equivalent" equity contribution.
4. Under the original HVCRE Regulations, however, borrower <u>does</u> <u>not</u> <u>receive</u> the benefit of the property's appreciation in value.
5. Illustration: If the land was purchased for $3 million, the invested capital is equal only to the original purchase price. Borrower would need to add $12 million of cash to meet a $15 million (15%) threshold on a $100 million "appraised as completed" project.

II. New Rules and Modifications -- HVCRE ADC Statute (Public Law 115-174; Senate 2155) (enacted May 24, 2018)

A. Risk Weight for HVCRE ADC Loans: 150% of the Loan Amount (Remains Unchanged)

B. Scope of Loans: A Real Estate Loan That, Prior to Being Reclassified by the Depository Institution as a Non-HVCRE ADC Loan:

1. Primarily finances acquisition, development or construction;
2. Has the purpose of providing financing to acquire, develop, or improve real property into income-producing real property; and
3. Is dependent upon future income or sale proceeds for repayment.

C. Exemptions:

1. 1-4 unit family residential property
2. Community development investment
3. Agricultural land
4. Acquisition or refinancing of income-producing real property if cash flow is sufficient
5. Improvements to existing income-producing real property if cash flow is sufficient to cover the loan payments and expenses of the property
6. Projects with:
   (a) Loan-to-value ratio less than 80% and
   (b) 15% borrower contributed capital and
   (c) Borrower's capital contribution is required to remain in the project until reclassification -- but only the minimum amount of capital (15%).

D. There is No Prohibition on Withdrawal of Excess Capital or Internally Generated Cash (as Long as 15% Equity Remains in the Project)

E. Definition of Permanent Loan: Based on the "Institution's Applicable Loan Underwriting Criteria for Permanent Financings"

F. Conversion of the Loan to Non-HVCRE ADC:

1. "Upon
   (a) Completion of construction; and

(b) When cash flow is sufficient to support the debt service and expenses of the property, to the satisfaction of the lender in accordance with its permanent financing criteria."

G. Contributed capital may take the following forms:

1. Cash;
2. Unencumbered readily marketable assets;
3. Paid out-of-pocket development expenses; or
4. Borrower's contributed real property or improvements.

H. Borrower's Contributed Capital can Equal 15% of the Current "Appraised as Completed Value" of the Property -- Borrower Obtains the Benefit of Property Appreciation

III. Key Clarifications (Improvements) in the New Legislation

A. Once the Development/Construction Risk Period has Passed, and the Project is Cash Flowing, Borrowers may Remove and Use Internally Generated Cash Outside the Project.

B. Loans Made for General Upgrades and Other Improvements on Existing Properties with Existing or Continuing Rental Income, Even After Acquisition, Do Not Trigger the HVCRE ADC Risk Weight Capital Penalty.

C. Property Appreciation Qualifies for the "Contributed Capital" Requirement --

1. Banks can establish borrower's current land value as "contributed equity" into projects in accordance with certain safeguards, such as a fully-compliant (FIRREA) current appraisal.

D. Grandfathering

1. HVCRE ADC excludes from application and compliance requirements any loans made before January 1, 2015.

E. The Legislative Action is a Solution Welcomed by Developers and Lender Alike

1. The regulatory scheme is now more well-matched with the lender's risk.
2. The attendant cost burden to commercial banks and their developer customers should be materially alleviated as a result.
3. The new legislation should enable commercial banks to increase their construction lending activities.