



This Webcast Will Begin Shortly

If you have any technical problems with the Webcast or the streaming audio, please contact us via email at:

accwebcast@commpartners.com

Thank You!



Distressed Real Estate Solutions

April 28, 2009

Association of Corporate Counsel
www.acc.com

Mortgage Loan Defaults and Workouts in a Distressed Economy – Lender and Borrower Perspectives

Establishment of the Default (“Event of Default”)

- Can be payment and/or non monetary
- Maturity date issue of particular significance in current environment given lack of access to re-finance capital
- Procedural requirements – grace periods and notice requirements are often conditions precedent to the occurrence of an “Event of Default”

Note: Importance of strict compliance with method of delivery, parties to receive notice, calculation of time periods.

- Failure of lender to exercise remedies may be treated as “substantial modification” of debt, with potential cancellation-of-debt income to borrower and/or recognition of gain by lender

Post-Default Negotiations and Workouts - Factors in Negotiating Leverage; Cost Benefit Analysis for Borrowers, Guarantors and Lenders

- For borrower, risk of mortgage foreclosure, resulting in loss of property and potential adverse tax consequences
- For guarantor/indemnitor, risk of recourse liability
- For lender, risk of borrower bankruptcy and lender liability litigation, risk and expense of ownership/management of collateral, and evaluation as to whether lender or its agents will have the ability to improve the borrower's management performance

Note: Special purpose entity (“single asset”) borrower form of organization gives lender substantial leverage in negotiations, due to Bankruptcy Code provision accelerating relief from stay for single asset real estate owners.

Note: Regulatory requirements may constrain lender flexibility in workout situations – particularly in conduit/secured transactions.

Note: Potential adverse tax consequences to lender may further constrain lender flexibility in workout situations – particularly in conduit/secured transactions or when loan has been purchased by lender at a discount.

Typical Lender Pre-Negotiation Letter Requirements

- Waiver of prior claims by borrower and guarantor
- Reservation of lender's right to continue to pursue remedies
- Waiver of automatic stay in event of bankruptcy
- Joinder by all borrower and guarantor parties
- Non-binding nature of discussions; condition of any required internal approvals
- Disclosure of current entity and property information
- Borrower acknowledgement re representation by counsel, lack of duress

Loan Restructuring Options

- Forbearance from exercise of remedies for a stated time period
- Extension of maturity date
- Principal – pay down, adjustment of amortization schedule, addition of amortization if interest only loan
- Interest rate adjustments (up or down); accrual vs. current payment; compounding of accruals
- Application of existing reserves or creation of new reserves

Loan Restructuring Options (cont.)

- Addition of new parties – for borrower, new partners/members; for lender, new participants
- Additional parties liable (e.g., guarantors) and/or increase in recourse liability
- Additional collateral
- Equity kicker for lender

Note: Most of the listed options for restructuring will be treated as “substantial modifications” of debt, with potentially adverse income tax consequences to both borrower and lender.

Note: REMIC rules generally prohibit significant modifications (which would include changes in payment terms and/or collateral) of loans in most circumstances unless “occasioned by a default or a reasonably foreseeable default,” but there are two safe harbors under REMIC rules, specifically:

- The lender may modify the payment terms of a loan as long as it does not change the yield by more than the greater of (i) $\frac{1}{4}$ of one percent and (ii) 5% of the original yield
- The lender may defer payments under a loan during the “safe harbor period” that begins on the date the first deferred payment was originally due and extends for a period equal to the lesser of (i) 5 years and (ii) 50% of the original term of the loan

Determination of Parties Liable

- Borrower entity – typically but not always a single purpose entity

Note: Consider any cross-default or cross-collateralization agreements

- Role of independent manager in single purpose entity
- Recourse vs. non-recourse loan

Note: Potential conflict of interest between develop/guarantor on one hand and non-recourse investor on the other.

- “Springing recourse” often triggered for entire loan by voluntary or collusive bankruptcy filings

Note: Enforceability may be challenged, but significant guarantor risk.

- Guarantor liability – non-recourse carve-outs, springing recourse, environmental indemnities, deficiency judgments
- Environmental indemnities – may include separate indemnitor (typically non-recourse carve-out guarantor) as well as borrower

Determination of Authorized Lender Representative

- Securitization has created multiple layers of authority (bondholders, trustees, master servicers, special servicers, rating agencies), resulting in great difficulties in executing a successful workout
- Participating loans – not as difficult as securitized loans, but lender authority to execute workout will typically be conditioned upon consent of a required percentage of participating lenders

Lender's Analysis of Existing Mortgage Collateral

- Rental income – single or multiple tenancies; tenant credit; security deposits (cash vs. letters of credit); lease maturity dates
- Cash flow controls – lock box accounts or automatic withdrawal mechanisms
- Reserves
- Current financial statements
- Property appraisal
- Physical conditions report
- Environmental assessment
- Title insurance update
- Status of any tax abatement proceedings – lender will seek to ensure that any abatement proceeds are factored into any workout and/or captured in any foreclosure sale

Lender Liability Risk Mitigation

- Loan document provisions
 - Merger and integration clauses
 - Amendments only in writing
 - No waiver of default clauses
 - Exclusion of consequential damages
- Post-default best practices
 - Reduce all agreements to writing
 - Memorialize all material conversations, including memos to the file and maintenance of telephone logs
 - Take care in preparation of internal reports, as they may be discoverable
- General standard of care – commercially reasonable practices
 - Avoid precipitous action and sudden changes in pattern of dealing
 - Negotiate in good faith

Loan Collection in a Distressed Economy: Deeds in Lieu, Foreclosures, and Lender Environmental Liability

Deeds in Lieu of Foreclosures

- Transfer to lender or its affiliate of title to real estate, in exchange for a release of borrower liability
 - Benefits are speed, limited transaction costs, and continuity of property control
 - Risks are lender assumption of intervening liens, undisclosed liabilities, and subsequent avoidance as a fraudulent transfer
- Entity selection for acquiring entity – use of single purpose entity provides liability protection; consideration should be given to “doing business” and foreign qualification requirements for out of state entities
 - State tax and licensing requirements can be a heavy burden if a party inadvertently is deemed to be doing business in a state

Deeds in Lieu of Foreclosures (cont.)

- Issues to be negotiated
 - Scope of release of borrower and guarantors
 - Transaction costs
 - Liability under existing leases, such as tenant improvements, brokerage commissions
 - Liability for entitlements, sales and leasing commitments in context of development projects
 - Termination of unfavorable contracts with borrower affiliates or third parties
- Due diligence prior to transfer

Foreclosures

- Methods of foreclosure are governed by state law
 - Foreclosure by private sale under statutory power of sale
 - Soldiers and Sailors Civil Relief Act
 - Judicial foreclosures

Comparison of Foreclosure and Deed in Lieu Transactions

- Foreclosure eliminates rights of junior lien holders
- Foreclosure not as vulnerable to a claim of fraudulent transfer
- Foreclosure is likely to be more expensive than a deed in lieu transaction, and could result in greater property deterioration due to length of process

Other Considerations in Preparing Foreclosure Strategy

- Single action rule – some states require an election of remedies, and void collection actions if pursued in violation of statutory requirements regarding collection sequence
- Potential for borrower bankruptcy – upon bankruptcy filing, all collection and foreclosure activities by the lender must cease

Pre-Foreclosure Remedies to Obtain Rents, Property Control

- Mortgage in possession – more immediate and less expensive than receivership, although imposes upon mortgagee expense and liability associated with property management
- Receivership – more expensive, legally intensive

Borrower Tax Consequences

- Deeds in lieu and foreclosure sales are treated as taxable sales, producing gains or losses for the borrower
- If the debt is nonrecourse, the sale price is the amount of the debt
- If the debt is recourse, the sale price is the fair market value of the property transferred to the mortgagee
 - If the debt is greater than the fair market value of the property, the debt in excess of the fair market value is treated as cancellation-of-debt income, normally taxable as ordinary income
 - Cancellation-of-debt income can be excluded from taxable income in certain circumstances and, under 2009 legislation, may be deferred until 2014 in other circumstances

Special Mezzanine Loan Issues in a Distressed Economy

Mezzanine Debt Generally

- Borrower of mezzanine debt is typically the sole member of the mortgage borrower
- Collateral is the ownership (e.g., membership) interest in the property owner – upon foreclosure, mezzanine lender (or buyer) becomes the owner of the property-owning entity
- Mezzanine debt is often securitized, leading to difficulty in achieving successful workouts due to conflicting interests of the holders of the mezzanine debt
- Intercreditor Agreement typically governs relationship between mortgage lender and mezzanine lender

Issues under Typical Intercreditor Agreements

- Standstill
- Mezzanine lender rights to buy first mortgage debt
- Transferee of the mezzanine loan – must it be a “Qualified Transferee”
- Obligation to provide replacement guaranty upon mezzanine loan foreclosure
- Cure rights for mezzanine lender
- Rating agency requirements – “No Down-Grade Letter” from the rating agencies prior to enforcing any mezzanine lender remedies
- Agreements regarding bankruptcy – often the mezzanine lender will have agreed to support (or not to oppose) the mortgage lender

UCC/Foreclosure Process

- May be through a private sale or a public auction; in a private sale, however, the mezzanine lender probably may not be the purchaser under the UCC
 - Advisable to do substantially the same marketing (and, as applicable, similar procedure) as that used in undertaking a commercial mortgage foreclosure

Securities Issues

- It is important to remember that a membership or partnership interest is typically considered a security and the sale must comply with various securities laws, typically requiring that any purchaser be a Qualified Investor

Issues for Mortgage Lenders Superior to the Holders of Mezzanine Debt

- Understand the rights and restrictions governing the mezzanine lender under the intercreditor agreement and applicable law
- Consolidation – Understand the risk that a special purpose entity mortgage borrower will be consolidated with the mezzanine borrower, potentially jeopardizing the mortgage lender's position in bankruptcy

Contact Information



Katharine E. Bachman

Phone: 617-526-6216

Email: katharine.bachman@wilmerhale.com



Keith R. Barnett

Phone: 617-526-6930

Email: keith.barnett@wilmerhale.com



Kathryn Lachelt Brown

Phone: 617-914-2515

Email: KathrynBrown@forestcity.net



Thank you for attending another presentation from
ACC's Desktop Learning Webcasts

Please be sure to complete the evaluation form for this program as your comments and ideas are helpful in planning future programs.

If you have questions about this or future webcasts, please contact ACC at accwebcasts@acc.com

This and other ACC webcasts have been recorded and are available, for one year after the presentation date, as archived webcasts at **www.webcasts.acc.com**.

You can also find transcripts of these programs in ACC's Virtual Library at **www.acc.com/vl**