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Distressed Real Estate Solutions

April 28

Association of Corporate Counsel
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Mortgage Loan Defaults and Workouts in a Distressed Economy – Lender and Borrower Perspectives

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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

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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

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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) ¼ 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

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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 developer/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

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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 lead lender authority to execute workout will typically be conditioned upon consent of a required percentage of participating lenders

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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

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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

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

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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

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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

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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

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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

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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

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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

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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

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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

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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

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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

LLC, Partnership and Other Joint Venture Issues in a Distressed Economy

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Overview of Joint Ventures

- Most commonly LLCs, but can be limited partnerships, general partnerships, corporations or other entities
- It is important to understand the identity of participants in a joint venture and their potentially differing motivations
 - Local “Developer Partner” – often has limited cash invested, but significant sweat equity and significant share of the upside; may also have primary liability under guaranties and other recourse obligations
 - Institutional Investor – often an investment advisor, pension fund or life company; usually has a majority of cash equity invested and significant control rights during times of duress

Note: If an institutional investor is a closed-end fund nearing its expiration, that may complicate negotiations due to pressure to execute fund exit strategy.

- Others, including passive players who contributed land to the joint venture, and anchor tenants who negotiated ownership of an equity interest as part of their deal

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Differing Interests of Joint Venturers

- Different exposures to recourse liability under loans
- Different tax implications for joint venturers
- Reputational and/or non-economic interests of joint venturers

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Capital Contribution Obligations

- Who decides whether to make a capital call
- Assuming that there are unbudgeted expenses, which parties are responsible for their payment
- What are the remedies for failure to answer a capital call – some typical possibilities include:
 - High interest rate loan
 - Priority distributions to the non-defaulting party
 - Punitive dilution
 - Non-punitive dilution
 - Forfeiture by the defaulting party of decision-making and/or other rights
 - Buy/sell or option to purchase – if option to purchase is at fair market value and the property is under water or near under water, an option to purchase might be an effective way to eliminate a recalcitrant venturer

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Dispute Resolution

- Even among sophisticated players, joint ventures have many varied dispute resolution procedures; for example:
 - None specified because “we are all partners” and the parties have assumed that they will work matters out; such an approach can leave parties with considerable doubt (and litigation risk) in the event of a distress situation
 - Buy/Sell
 - Typically one party will have an advantage if it has deeper pockets
 - Developer/operating partner may have more property-specific knowledge than the investor partner, potentially providing leverage in negotiations; yet there is the risk of a breach of fiduciary duty to the investor partner if the developer fails to make a timely disclosure of material information
 - Care must be paid that the transfer of interest will not trigger an event of default under loan documents

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Dispute Resolution (cont.)

- Buy/Sell (cont.)
 - Important to understand the process for Buy/Sell – if a lengthy process, may not be practicable as the asset becomes further devalued – processes are varied but include:
 - Shotgun
 - Baseball Arbitration
 - Averaging Arbitration
 - Sometimes (but not usually) there are discounts for minority interests and/or illiquidity
- Forced sale of the asset – if this is the only remedy, of course, it is likely to be unappealing in a time of distress in the market
 - Which venturer controls the sale and within what parameters?

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Landlord/Tenant Issues in a Distressed Economy

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Tenant Default

- Application of security to lease default – if a security deposit is available, landlords should apply upon occurrence of event of default, with a simultaneous demand of replenishment to the tenant

Note: If tenant has made a bankruptcy filing, application of a cash security deposit is barred by the automatic stay; under “independence principle”, application of letter of credit after filing may be exempt from stay but vulnerable to challenge, especially if draw results in an increase in secured debt under the tenant’s letter of credit agreement with issuer.

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Lease Termination Agreements

- Efficient means of termination of tenancy by mutual agreement of landlord and tenant
- Vulnerable to avoidance as a fraudulent transfer (4 year statute of limitations under majority of state laws) or preference (within 90 days prior to tenant bankruptcy filing)

Tenant Bankruptcy

- Automatic stay invoked upon tenant bankruptcy filing
Note: Termination of lease prior to tenant bankruptcy filing gives landlord much greater control (although relief from automatic stay may be advisable if there is a question as to the validity of the lease termination).
- Acceptance or rejection of lease – decision must be made by tenant within 120 days of filing, but Bankruptcy Court may extend upon tenant request for an additional 90 days; any extension beyond 210 days requires landlord consent

Tenant Bankruptcy (cont.)

- Cap on damages recoverable upon rejection of lease rental obligations prior to filing equal to (a) rent due and unpaid under lease prior to rejection, plus (b) rent after rejection equal to the greater of (i) one (1) year's rent, or (ii) 15% of the rent reserved under the lease (not to exceed three (3) years)

Note: Most courts direct application of security deposits to the capped claim.

- Assignment of lease after assumption is generally permitted by Bankruptcy Courts, overriding any lease anti-assignment provisions

Landlord Bankruptcy

- If the landlord rejects the lease, tenant has two options:
 - Tenant may treat the lease as terminated, or
 - Tenant may retain its rights under the lease
- In the event of a rejection of the lease and retention of rights by the tenant, the tenant may offset against rent any damages suffered by the tenant for the landlord's nonperformance of its obligations after lease rejection by the landlord

Note: Tenant decision to treat a lease rejected by the landlord as terminated will depend upon the desirability of lease location and rental terms, as well as the tenant's ability to exercise self-help rights successfully to overcome nonperformance by landlord (easy in a single tenant, triple net lease situation, difficult for a small retail tenant in a shopping center).

Mortgage Loan Purchase Opportunities in a Distressed Economy

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Acquisition Alternatives

- Acquisition of single loan
 - Consider necessity to acquire junior liens to obtain property control
 - Consider necessity to arrange for borrower forbearance from bankruptcy relief to achieve strategy of fee acquisition through foreclosure
- Loan portfolio sale
- Commercial mortgage backed securities

Note: Loan sales transactions are likely to accelerate over the next several years, given the large volume of commercial mortgage loans maturing in 2009/2010.

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Tax Concerns

- Restructuring of loan after purchase at discounted price (or foreclosure sale with a bid price in excess of loan purchase price) can cause purchases to realize significant “phantom” gain

Due Diligence Checklist for Loan Acquisition

- Loan document review
 - Conformance with purported business terms
 - Completeness of documentation
- Status of post-closing obligations and arrangements
 - Payment of real estate taxes and other municipal liens
 - Insurance coverages
 - Establishment of reserves
 - Completion of improvements/repairs to mortgaged property
 - Satisfaction of regulatory requirements
 - Status of any lock-box arrangements

Due Diligence Checklist for Loan Acquisition (cont.)

- Title/survey
- Lease matters
- Contract matters
- Property condition
 - Environmental assessment
 - Physical condition report
 - Regulatory review

Key Provisions of Loan Assignment Agreement

- Business terms – loan purchase price (at par, discount, or premium); time of closing
- Representations and warranties
 - Due authorization to enter into transaction
 - Assignor as sole holder of loan; no liens/encumbrances/prior pledges of assignor's interest in the loan
 - Amount of outstanding loan balance and date of last payment
 - Status of loan – absence of borrower/guarantor default, or nature of default, if any; absence of borrower basis for lender liability/defense to collection
 - Amount of outstanding reserves; original balance and any disbursements
 - Delivery of complete and correct copies of loan documents and all amendments/modifications
 - Delivery of copies of all notices/correspondence with borrower/guarantor
 - Delivery of all due diligence

Key Provisions of Loan Assignment Agreement (cont.)

- Representations and warranties (cont.)
 - Status of any litigation
 - Status of any tenant defaults, litigation or bankruptcy
 - Existence of any brokerage arrangements and responsibility for commissions

Note: The duration of representations and warranties, floors and caps on assignor liability, and recourse for liability arising from breach of representations and warranties will be the subject of negotiation.

Selected Bankruptcy Issues Affecting Distressed Real Estate

Primary Proceedings under US Bankruptcy Code

- Chapter 7 liquidation
- Chapter 11 reorganization

Bankruptcy Sales Under Section 363

- Section 363 sales provide for the sale of assets “free and clear of any interest in such property”

Note: In situations where the assets being sold account for substantially all of the assets of the debtor, such as may be the case with a single asset real estate debtor, consideration must be given whether to complete the sale under Section 363, and risk the sale being challenged as a “sub rosa” plan for reorganization, or to complete the sale through an actual plan of reorganization, which generally takes more time to complete.

- Secured lenders and mortgage holders may “credit bid” their debt
- Section 363 sales are typically conducted through an “auction” type of process, often with stalking horse bidders and breakup fees
- Care must be given to avoid collusive bidding between potential purchasers to control the purchase price of the property being sold – collusion can lead to the sale being unwound, and the colluding parties may be subject to potential monetary or criminal punishment

Automatic Stay

- The automatic stay is intended to provide the debtor with a “breathing spell,” and stays, among other things, all actions against the debtor which were commenced or could have been commenced prior to the commencement of the bankruptcy case; for example:
 - Mortgagees must suspend all actions to collect the loan
 - Landlords must cease any eviction or collection actions against a tenant

Motion for Relief from the Automatic Stay

- For cause, including: failure to maintain and preserve collateral, waste or mismanagement by the debtor, failure to pay taxes, and undue delay by the debtor in proposing a reorganization plan
- If (a) the debtor does not have equity in the property, and (b) such property is not necessary for an effective reorganization (Sec. 362(d)(2))
- Single asset real estate – relief from stay is available to a creditor whose interests are secured by such real estate unless, not later than 90 days after the bankruptcy order for relief (or a later date as the court may determine within such 90 days) or if later, 30 days after the court determines that the debtor is in a single asset real estate, either (A) the debtor has filed a plan with a reasonable possibility of being confirmed within a reasonable time, or (B) the debtor has commenced monthly payments in an amount equal to interest at the then applicable non-default contract rate on the value of the creditor's interest in the property

Fraudulent Transfers

- Defined under Bankruptcy Code Section 548 (look back is 2 years) or state law (look back is 4 years under Uniform Fraudulent Transfer Act), whichever is longer, generally requires either a showing of:
 - “Actual fraud” or
 - “Constructive fraud” which typically requires both a transfer for less than reasonably equivalent value, and a determination that the transferor was insolvent at the time, or became insolvent as a result of the transfer or had unreasonably small capital or expected to incur debts beyond its ability to pay

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Preferences

- Payments (or other transfers of property, including pledges or grants of additional collateral) can be recovered by the debtor’s estate in bankruptcy as preferences if made within 90 days prior to commencement of bankruptcy (1 year if to an insider) if the payment or transfer was:
 - Made on account of an antecedent debt,
 - While the debtor was insolvent (with a presumption of insolvency applying in the 90 days before filing), and
 - Enabled the creditor to receive more than it would have in a Chapter 7 liquidation
- Key defenses to assertion that payments or transfers constituted preferences include transfer in the ordinary course of business according to ordinary terms

Note: For this reason, creditors will typically want to take routine and regular steps to help ensure that payments do not slide significantly beyond their due dates; “ordinary course” is defined on a case by case basis, but the more routine the payment schedule, the stronger the case for a creditor that such payments were not preferential.

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Reorganization Plans

- Confirmation of a Plan – a plan can be confirmed over a mortgagee’s objection through a “cramdown” which complies with the absolute priority rule
 - Cramdowns – typically with respect to a secured creditor (including a mortgagee), such a plan must satisfy one of the following:
 - Mortgagee retains its security interest to the extent of the value of property and is entitled to deferred cash payments with a present value of at least the mortgagee’s interest in the collateral
 - Sale of the collateral, subject to the mortgagee’s lien (with mortgagee generally able to credit bid at such sale) or
 - Mortgagee receives the “indubitable equivalent” of its secured claim, the determination of which is made by the court on a case by case basis
 - Absolute Priority Rule – senior classes (e.g. secured mortgage creditors) must be paid in full before any junior classes (e.g. equity) can receive any value
 - Some courts have applied a “New Value Exception” whereby a junior class can receive value even if senior classes are not paid in full, but if existing shareholders are to retain or obtain an interest through the new value exception, the value of that interest must be set in some way by market forces

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PPIP (Public-Private Investment Partnerships)

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PPIP

- Goal is to entice private sector to create a market for banks' bad assets; maximize current value of those assets; and allow banks to cleanse balance sheets
- Opportunities for private investors to employ significant leverage with no recourse other than initial investment
- Banks, working with FDIC, decide what to sell; expectation is that "worst is first," because banks have already written down values (mostly residential)
- Two categories of assets with two different programs:
 - Loans
 - Mortgage-backed securities

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PPIP - Loans

- Anyone can play on the buy side, subject to FDIC approval
- FDIC selects eligible banks and works with them to select assets to be sold
- Private investor joins with Treasury in a public-private investment fund; equity requirement can be as low as 8%, with Treasury matching and the rest being debt provided by selling bank (or another source) and guaranteed by FDIC
- If investment successful, private investor gains, and on a highly leveraged basis; if investment fails, private investor loses its investment but there is no further recourse; taxpayers absorb the rest of the loss

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PPIP - Securities

- Eligible seller rules broader than for loan program
- Only very large institutions already in the business of managing these securities can play though these rules may be loosened
- Approved asset managers raise private funds; Treasury matches and invests side by side
- TARP loans may be available for 50-100% of total fund equity
- Funds can acquire only certain securities (non-agency, originally AAA, not CDOs)
- Same risk/reward analysis as for loans: if investment successful, investor wins; if unsuccessful, taxpayer loses

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PPIP – Risks and Questions

- Many mechanical and logistical issues not yet resolved: extent of government control over its private partners; governance rules; fees; forms of fund agreements, management agreements, purchase agreements; auction and bidding process
- Treasury says executive compensation limits do not apply, but rumors on Capitol Hill suggest continued debate in this area
- Private investors will have the government as a partner (FDIC for loans, Treasury for securities); government will have broad oversight rights in a highly-charged environment
- Fear that rules will change if private investors profit too handsomely
- Because of tax issues, foreign investors and tax-exempts face complications, especially for the loan program

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