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Distressed Real Estate Solutions Group

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OUR DISTRESSED REAL ESTATE SOLUTIONS GROUP

Our firm's seasoned Real Estate practitioners bring extensive experience critical to the successful repositioning of real estate relationships made necessary by the current economic crisis, and to the representation of investors seeking value transactions in anticipation of future economic return. This skill set includes mortgage workouts, lease renegotiations, venture restructurings, and loan collections, in concert with the firm's strong bankruptcy, litigation, tax, and environmental risk management practices. We represent mortgagees and mezzanine lenders, developers, investors, landlords and tenants in different contexts, giving insight into the different imperatives which motivate the parties. Our extensive experience in foreclosures has serviced the needs of institutional lenders, as well as investors using the acquisition of loans and exercise of remedies as a means to property acquisition. Our fund formation group is expert in the creation of investment vehicles for the acquisition of property, venture interests, and loans.

Representative experience includes:

- Over the past 20 years, conducting over 75 foreclosures for institutional lenders and investors, with related litigation and bankruptcy, involving all real estate asset classes, including office buildings, multi-family apartments, hotels and industrial properties
- Development and implementation of environmental risk management strategies in connection with numerous workouts, foreclosures and bankruptcy proceedings involving distressed real estate
- Workouts and restructurings (and in several cases the associated foreclosures and sales of underlying assets) related to 15 loans aggregating $200+ million contributed to a troubled debt fund and secured by properties in seven states for a major state pension fund and its investment advisor
- Financial and ownership restructuring and $100 million sale in connection with a troubled multi-family condominium development in southern California for an institutional investor
- Representation of an acquirer of a $120 million mortgage loan and simultaneous deed-in-lieu for 15 of the 20 properties securing the loan.
- Representation of KB Toys during its emergence from bankruptcy in the restructuring and sale to a REMIC of mortgage loans secured by its warehouse facilities in multiple states
- Partnership takeover and restructuring of a defaulted construction loan for a failed condominium project in Maryland for an institutional investor

For additional information on our Distressed Real Estate Solutions Group, please click here: http://www.wilmerhale.com/real_estate/distressed/

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

Establishment of the Default ("Event of Default")

- Payment defaults – right to cure vs. immediate acceleration; non-payment of periodic debt service vs. non-payment at maturity
- Non-monetary defaults
  - Financial covenants – loan to value, debt service coverage ratios; liquidity; net worth; may be applicable to guarantor as well as borrower
  - In balance requirement – in construction loan context, requirement that loan balance is sufficient to complete project
  - Material adverse change – lender deemed "insecure"

  NOTE: Borrower will consider cure alternatives of loan pay down, additional security, reappraisal.

  - Schedule defaults – consider whether failure to meet contract schedule/milestone requirements is excused by "force majeure" (events outside the performing party's control)

  NOTE: Force majeure definitions vary, and often exclude financial incapacity (although this exclusion is being debated currently due to global economic crisis).

  - Other defaults include unauthorized transfers of interests in borrower, failure to maintain mortgaged premises, failure to carry required insurance, unauthorized alterations, unauthorized leasing
- 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
    - Foreclosure can yield cancellation-of-debt income or capital gain for borrower depending on the value of the property and whether the debt is recourse or nonrecourse
    - Restructuring of debt, however, may produce cancellation-of-debt income for borrower and/or recognition of gain by lender if restructuring is a "substantial modification" of the debt
  - 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
  - Availability of resources to structure a workout which sufficiently compensates the parties and has benefits which outweigh the cost and delay of bankruptcy and litigation

NOTE: Special purpose entity ("single asset") borrower form of organization gives lenders 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/securitized transactions.

NOTE: Potential adverse tax consequences to lender may further constrain lender flexibility in workout situations - particularly in conduit/securitization transactions.

- Both parties will typically want to make clear that all communications are for "settlement purposes only, with all rights reserved"
- 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

  NOTE: Enforceability may be challenged but will give lender leverage in context of later bankruptcy by borrower.

  - 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 (see discussion on lender’s analysis of collateral, below)
  - 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
  - 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 mortgage collateral
- Equity kicker for lender
    - If debt was originally nonrecourse and "kicker" is true equity interest in borrower partnership, borrower (or partners) may have adverse tax consequences due to deemed conversion to recourse debt
    - "Bottom guaranties" or similar mechanisms may prevent adverse tax results
- Additional lender protections in documentation (see discussion of lender liability, below)
- Payment of lender costs, additional fees

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

NOTE: Restructuring terms may require consent of parties in addition to borrower and lender (such as borrower investors and/or independent manager, guarantors, junior creditors, loan participants; in securitized loan context, negotiating terms will be proscribed by servicing agreements, indenture terms and, where applicable, REMIC rules); 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

NOTE: The Treasury Department is considering further exceptions, and has already announced that it will not treat most modifications to subprime residential mortgage loans as causing a problem for REMICs based upon its administrative interpretation that such modifications are "occasioned by a default or a reasonably foreseeable default".

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
  - Non-recourse carve-out liability - parties liable will include borrower and non-recourse carve-out guarantor; may include prior parties if loan was assumed

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

  NOTE: Nature of debt as recourse or non-recourse likely will affect whether foreclosure would produce cancellation-of-debt income or capital gain; preferable type of income will depend upon economic and tax position of borrower.

- Liability may be limited to damages arising from breach of non-recourse carve-out (such as unpaid taxes or insurance premiums, or rents received after the default), or may trigger liability for entire loan and recourse to rents received prior to default and not applied to debt service and property operating expenses
- "Springing recourse" often triggered for entire loan by voluntary or collusive bankruptcy filings

  NOTE: Enforceability may be challenged but significant guarantor risk.

NOTE: Springing recourse may be "substantial modification" of debt, producing cancellation of debt income for borrower and/or gain for lender.

- 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

- Prior to conduit lending and securitization, workouts were typically two-party negotiations between lender and borrower
- Securitization has created multiple layers of authority (bondholders, trustees, master servicer, special servicer, 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 be conditioned upon consent of the 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 – repair or replacement; tenant improvements and brokerage commissions for re-leasing; taxes and insurance; debt service
- Borrower and guarantor current financial statements
- Property appraisal
- Physical conditions report

- Environmental assessment - review of original loan due diligence and current Phase 1
- 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
  - Disclaimer of negligence liability of lender
  - Exclusion of consequential damages
  - Choice of law and forum clauses
  - Waiver of trial by jury
- 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
  - Avoid taking control of the mortgaged premises if possible
  - Negotiate in good faith
  - Give adequate notice prior to calling a loan or terminating a line of credit

Special Issue in the Event of FDIC Receivership of a Failed Federally Insured Bank

- Federal statutes and case law protect the FDIC against oral or unrecorded agreements not in the bank's records

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

[NOTE: See separate outline for Mortgage Loan Defaults and Workouts]

Deeds in Lieu of Foreclosure

- 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 (such as junior mortgages, mechanics liens and attachments), undisclosed liabilities, and subsequent avoidance as a fraudulent transfer (transfer for less than reasonably equivalent value while borrower was insolvent)

  NOTE: Better practice is to foreclose rather than accept a deed in lieu of foreclosure, particularly if there are uncooperative parties (such as borrower investors, junior creditors) or risk of undisclosed liabilities.

  NOTE: Either deed in lieu or foreclosure may be more beneficial to lender for tax purposes than debt workout; no "phantom" gain resulting from "substantial modification" of debt; ability to claim loss.

- Entity selection for acquiring entity (applicable both to deed in lieu and foreclosure transactions) – 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
- Issues to be negotiated

- Scope of release of borrower and guarantors – lender reservation of recourse for representations and warranties, fraud, bankruptcy claw back, environmental liability
- Transaction costs – transfer taxes and recording fees, title insurance, other due diligence
- Liability under existing leases, such as tenant improvements, brokerage commissions
- Liability for entitlement, sales and leasing commitments in context of development projects
- Termination of unfavorable contracts with borrower affiliates or third parties

- Due diligence prior to transfer
  - Property operating statements
  - Leases
  - Title
  - Environmental assessment
  - Real estate taxes and betterment assessments
  - Management and service contracts
  - Sales or leasing commitments
  - Entitlement obligations
- Mechanics of deed in lieu of foreclosure transaction
  - Settlement agreement should memorialize terms of transfer, addressing issues identified above, as well as timing of transfer and any consideration to be paid to the lender in addition to property transfer
  - Title is transferred to lender or lender affiliate; mortgage often is left in place pending property disposition to preserve ability to foreclose out junior liens, relying upon anti-merger language in loan documents

NOTE: State transfer tax requirements must be satisfied, as the deed in lieu is a transfer of record title.

Foreclosure

- Methods of foreclosure are governed by state law
  - Foreclosure by private sale under statutory power of sale – conducted by attorneys and auctioneers, in accordance with legally proscribed notice, publication and sale requirements
  - Soldiers and Sailors Civil Relief Act – additional statutory protections against foreclosure actions for persons in the military service made applicable to the foreclosure process in some states
  - Judicial foreclosure – under court jurisdiction, initiated by complaint; court directs conduct of sale and disposition proceedings
- Comparison of foreclosure and deed in lieu transactions
  - Foreclosure eliminates rights of junior lien holders, deed in lieu does not
  - Foreclosure conducted in accordance with the requirements of state statutes and in a commercially reasonable manner will not be vulnerable to a claim of fraudulent conveyance under the United State Supreme Court decision in BFP v. RTC
  - 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 (depending upon jurisdiction requirements)
  - Due diligence requirements are applicable in both contexts (see above), to guide the lender's risk underwriting and prepare for acquisition of mortgaged property if necessary
- Some states have special statutory protections for residential homeowners which afford additional notice and cure rights prior to foreclosure; given national economic crisis; further statutory protections for homeowners and/or tenants affected by foreclosure may be adopted by federal and state governments
- Other considerations in preparing foreclosure strategy

- Deficiency – lender right to pursue a deficiency judgment against a borrower or guarantor in the event that the foreclosure is insufficient to satisfy the loan obligation and collection costs may be conditioned upon statutory notice requirements
- 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 due to the automatic stay imposed by the federal Bankruptcy Code; subsequent foreclosure action must follow granting of relief from stay by bankruptcy court
- Potential for lender liability suit to enjoin the foreclosure – pursued by borrowers in late 1980s real estate recession, but few borrower suits were ultimately successful

- Pre-foreclosure lender remedies to obtain rents, property control
  - Mortgagee in possession – process authorized under statute and loan documents under which mortgagee takes control of property; more immediate and less expensive than receivership, although imposes upon mortgagee expense and liability associated with property management
  - Receivership – lender petitions to seek a receiver for the mortgaged property; court appoints receiver for property operations and accounting to the court, but at the expense of the mortgagee to the extent not covered by property operations – more expensive, legal intensive

NOTE: Issue of whether mortgagee has a "perfected security interest" in rents if borrower files for bankruptcy prior to mortgagee in possession action was litigated under cases like Prichard Plaza; later decisions and amendment to federal Bankruptcy Code (Sec. 552(b)(2)) reversed prior case law and recognized mortgagee interest in rents, so long as rents were assigned under an appropriate assignment of rents in the loan documentation, notwithstanding a bankruptcy prior to the mortgage in possession action.

- Mortgagee bidding strategy at foreclosure – prior case law, such as the Durrette decision, directed mortgagees to bid at least 70% of the fair market value (determined by a current appraisal) of the mortgaged premises, in order to avoid a fraudulent conveyance claim by a bankrupt borrower; following the BFP v. RTC decision, an appraisal is not required if not required by state law, but bid should be guided by a standard of commercial reasonableness (such as assessed value, market comparables, or other lender valuation methodology)

- Sale mechanics

  - In the context of a private sale under a statutory power of sale, legal counsel manages the foreclosure process, engages an auctioneer to perform commercial advertising and conduct the sale itself, prepares legal notices and the memorandum of sale to be executed by the successful bidder, and closes the conveyance shortly after the sale, on the date specified in the memorandum of sale
  - In most states, lenders may bid in the amount of the debt and collection costs at the sale; this most frequently results in the lender becoming the successful bidder, after which the lender may dispose of the property by negotiated sale to a third party
  - If sale proceeds exceed the debt and collection costs, excess proceeds are typically delivered by the mortgagee into court in an interpleader action, for the court's determination as to the appropriate parties to receive the funds

<u>Borrower Tax Consequences</u>

- 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 fair market value of the property exceeds the amount of the debt, the borrower will be entitled to receive cash for such excess)

- If the debt is greater than the fair market value of the property transferred to the mortgagee, 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 including each of the following: (i) in bankruptcy; (ii) if borrower is insolvent; and (iii) if debt is "qualified real property business indebtedness"
  - Exclusion may require corresponding write down of "tax attributes" such as net operating losses and depreciable basis of property
  - Careful analysis of facts necessary to determine whether cancellation-of-debt income is preferable to capital gain from sale
  - For partnerships and limited liability companies, the bankruptcy or insolvency exception is determined at the partner level (i.e., not at the entity borrower level) and the reduction of tax attributes is made by the partners

Lender Environmental Liability Considerations

- Federal lender liability under CERCLA (Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended)
  - In 1990 Fleet Factors case, the court ruled that a lender could be held liable for environmental claims if its involvement in management was sufficient to influence the borrower's treatment of hazardous waste
  - 1996 CERCLA amendments gave protection to lenders from federal environmental liability, both pre- and post-foreclosure, so long as the foreclosing lender has not actually participated in management of the facility pre-foreclosure and seeks to dispose of the foreclosed property on commercially reasonable terms at the earliest practicable, commercially reasonable time
- Each state environmental statutory scheme must be reviewed prior to undertaking collection remedies to anticipate steps required for lender liability protection and avoid traps for springing liability for hazardous waste
- As with hazardous waste, states have adopted protections for lead paint contamination; consider state requirements for lender liability safe harbor protection

Special Mezzanine Loan Issues in a Distressed Economy

[NOTE: See separate outline for Mortgage Loan Defaults and Workouts]

Reasons for Growth of Mezzanine Debt

- The most significant reason for the explosion of mezzanine debt was the prohibition by securitized mortgage lenders and rating agencies of any indebtedness of the mortgage borrower, including mortgages junior to the securitized first mortgage
  - Perceived advantages from mortgage lenders' perspective include simpler foreclosure and elimination of forced bankruptcy of mortgage borrower
- Borrower of mezzanine debt is thus, typically, the sole member (or other beneficial owner) of the mortgage borrower and often, itself, a single purpose bankruptcy-remote entity
- 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, and effectively takes over as mortgage borrower
- Mezzanine debt is often securitized, leading to difficulty in achieving successful workouts due to conflicting interests of the holders of the mezzanine debt, potential conflicts regarding valuation, and liability of controlling holder to the holders of interests in other tranches
- Intercreditor Agreement typically governs relationship between mortgage lender and mezzanine lender

  NOTE: There are other esoteric reasons for specific mezzanine loans, especially efforts to mirror equity (with promoted returns, etc.) for an "investor" who could not (typically for tax reasons) invest in the underlying asset – often condominium or hotel projects.

Issues for the Holder of Distressed Mezzanine Debt

- Issues under typical Intercreditor Agreements
  - Standstill –what (if anything) may the mezzanine lender do to protect and enforce its rights and when (if at all) may the mezzanine lender take action
  - Right to buy first mortgage debt – at what price may a purchase option be available, such as at par or with prepayment premiums, default interest, etc.
  - Transferee of the mezzanine loan – to whom may the mezzanine lender transfer its interest in the loan; must it be a "Qualified Transferee"
  - Obligation to provide replacement guaranty – many intercreditor agreements will require that if the mezzanine lender realizes on its remedies, it must provide replacement guaranties to the mortgage lender
  - Cure rights – often the mezzanine lender will have a relatively short time frame in which to cure borrower mortgage loan defaults before the mortgage lender may exercise its remedies and wipe out the mezzanine lender
  - Restrictions on modification of loan documents – most intercreditor agreements will limit the mezzanine lender's ability to make material modifications to the mezzanine loan documents, thus making workout negotiations more difficult
  - Rating agency requirements – if the senior mortgage loan has been securitized, intercreditor agreements will often require that the mezzanine lender obtain a "No Down-Grade Letter" from the rating agencies prior to enforcing any of its remedies
  - Agreements regarding bankruptcy – often the mezzanine lender will have agreed to support (or not to oppose) the mortgage lender in connection with any bankruptcy motions; it is important to understand, early, what agreements are in place and the impact they will have on the mezzanine lender in the event of a borrower bankruptcy
- UCC/foreclosure process – foreclosure may be through a private sale or a public auction; in a private sale, however, except in the unusual circumstance where there is a recognized market for the interest being sold, the mezzanine lender may not be the purchaser

- In any event, in most cases it will be advisable to do substantially the same marketing (and, as applicable, similar procedures) as those used in undertaking a commercial mortgage foreclosure, because a principal challenge to the foreclosure by a borrower (or a trustee in bankruptcy) would be that the sale was not conducted in a commercially reasonable manner
- Often (almost always in securitized mezzanine loans) a title insurance policy is in place to insure the effectiveness of the pledge of the collateral

- Bankruptcy issues

  - It may be possible, under certain circumstances, that one or more parties to the operating agreement (or partnership agreement) in which the equity interests have been pledged to the mezzanine lender may attempt to reject that agreement in bankruptcy, jeopardizing the mezzanine lender's position
  - Recharacterization of mezzanine lender's interest – especially if the mezzanine loan was put in place to mirror a more typical equity investment (often done because of tax issues of the mezzanine lender that would make an equity investment impractical), the mezzanine lender may be recharacterized as a joint venturer or equity holder and creditors may seek to limit or eliminate its rights as a creditor
  - Equitable Subordination – if a mezzanine lender exerts undue influence on the mezzanine borrower, or has engaged in seriously inequitable conduct, creditors may seek to subordinate the obligations of the mezzanine lender to a position junior to other creditors
  - Consolidation – it is possible that the mortgage borrower and the mezzanine borrower would be consolidated for bankruptcy purposes (i.e., the mortgage borrower and the mezzanine borrower would be treated as one entity by the bankruptcy court), and it will be important to evaluate both the likelihood of this event and whether it would be beneficial or harmful to the mezzanine lender – typically consolidation will be good for the mezzanine lender and bad for the mortgage lender because it results in the mortgage lender and the mezzanine lender each being deemed a creditor of the consolidated debtor, providing the mezzanine lender with increased leverage in bankruptcy

- Securities issues – it is important to remember that a membership or partnership interest is typically considered a security and the sale thereof (whether through foreclosure or otherwise) 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
  - Standstill
  - Right to buy first mortgage debt (and at what price)
  - Definition of Qualified Transferee
  - Obligations to provide replacement guaranties
  - Cure rights with respect to mortgage defaults
  - Rating agency requirements
  - Agreements regarding bankruptcy
- 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

Issues for Borrowers in Distressed Mezzanine Loans

- Many of the restriction and risk issues described above may benefit the mezzanine borrower
  - Standstill
  - Challenges to the mezzanine lender in completing a commercially reasonable sale of the mezzanine interest
  - Possibility of consolidation with mortgage borrower
- Guaranties – borrowers (and their principals) will be particularly concerned with liability under guaranties and potential springing full recourse loan liability, based upon a bankruptcy filing or other specified default

- Fiduciary duty, conflicts of interest – in the event that the loan becomes fully recourse to a principal of the borrower on the filing of a bankruptcy or on the taking of other steps to thwart the lender, the principal may be in a position where it has a conflict of interest, as its fiduciary duty may, nevertheless, suggest that such a filing or other action is in the best interest of the borrower

- Determination of authorized lender representatives in the event that the mezzanine loan has been securitized (or participated) - it will be imperative for the borrower to understand the lender's decision-making authority in order to execute a successful workout (e.g., bondholders, trustees, master servicers, special servicers, etc.)

    - Master servicing, special servicing and other agreements may require rating agency action and will constrain decision-making

- Possible regulatory changes occasioned by the current economic crisis may create opportunities for more effective workouts; for now, document constraints and REMIC rules make securitized transaction workouts especially difficult

<u>Additional Issues Consistent with Mortgage Loan Issues</u>

- See the WilmerHale Distressed Real Estate Solutions Group outline on mortgage loan defaults with respect to various matters, including establishment of the default, determination of parties liable, analysis of existing collateral, post-default negotiations and workouts, lender liability risk mitigation and tax implications

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

Overview of Joint Ventures

- Most commonly LLCs, but can be limited partnerships, general partnerships, corporations or other entities

  NOTE: Analysis below generally applicable to all of such entities.

- In analyzing issues 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 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

Differing Interests of Joint Venturers

- Different exposures to recourse liability under loans

  - Often the developer partner will bear most or all recourse risk and will insist on a release as part of any workout; institutional investor will need to understand its rights and leverage, including potential need for a replacement guarantor for recourse liabilities under loan documentation

- Different tax implications for joint venturers in the event of foreclosure

- Taxpayers (e.g. developer partners) may recognize taxable capital gain and/or cancellation-of-debt income upon foreclosure; tax exempts (e.g. pension funds) may be indifferent
    - If tax-exempt partner is not a pension fund, or if partnership agreement does not comply with "fractions rule," gain or cancellation of debt income may be "unrelated business taxable income" on which tax-exempt pays taxes
    - Taxable gain and/or cancellation of indebtedness income may be allocated disproportionately between (or among) partners
- Taxpayers may recognize cancellation-of-debt income upon restructuring of loan if the restructuring is a "substantial modification" of the loan; tax-exempts may be indifferent (subject to same exceptions described above for foreclosures)

- Reputational and/or non-economic interests of joint venturers – local developers are much more likely to be worried about reputational impact than national or international investment funds

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, and, if so, degree of 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
- Disproportionate capital contributions used to pay down debt may have adverse tax consequences to smaller contributor due to reduction of basis upon reduction of debt

<u>Governance Issues</u>

- Does one venturer have unilateral control
  - Are there major decisions (such as the filing for bankruptcy, refinancing, etc.) that require super-majority approval, or, because of lender requirements, require approval of independent managers or other parties
- What is the process for budgeting – what happens if the budget is not agreed upon; does the prior year's budget carry over?
- In general, what happens if there is an impasse in the distress situation (see dispute resolution below)

<u>Dispute Resolution</u>

- Even among sophisticated players, joint ventures have many varied dispute resolution procedures; for example:
  - None specified – many joint venture agreements do not specify a dispute resolution procedure on the theory that "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 investor partner if developer fails to make a timely disclosure of material information

        - Before triggering this remedy, care must be paid that the transfer of interest will not trigger an event of default under loan documents not already in default
        - Important to understand process for Buy/Sell - if lengthy process, may not be practicable as the asset becomes further devalued – processes are varied but include:
            - Shotgun – one venturer names a value for the venture and the other decides whether to be a buyer or a seller
            - Baseball Arbitration – each side names a value (or each side names an appraiser that names a value) and then an arbitrator (or panel of arbitrators) picks one of the two suggested values as fairest
            - Averaging Arbitration – each side appoints an arbitrator and the two arbitrators pick a third arbitrator; all three arbitrators come up with a value and the closest two values are averaged for a final value
        - Sometimes (but not usually) there are discounts for minority interests and/or illiquidity
        - Structuring purchase as redemption from partnership (if economically feasible) rather than purchase by partner may allow departing partner to substantially defer recognition of taxable gain
    - 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?

Landlord/Tenant Issues in a Distressed Economy

Tenant Default

- Payment defaults – right to cure vs. immediate acceleration
- Non-monetary defaults – often coincident with non-payment of rent; material defaults include failure to maintain leased premises, unauthorized subletting, failure to maintain insurance
  - Schedule defaults – consider whether failure to meet any lease schedule/milestone requirements is excused by "force majeure" (events outside the tenant's control)

  NOTE: Force majeure definitions vary, and often exclude financial incapacity (although this exclusion is being debated currently due to global economic crisis).

- 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.

- Tenancy at will – default and termination governed by state law
- Constructive eviction as defense to tenant default
- Dependent covenants rule – national trend accepting dependent covenants rule under which tenants may avoid payment of rent after material landlord default (particularly with respect to condition of premises)

  NOTE: Landlords should include language in their lease forms which negate the "dependent covenants" rule.

- Application of security deposit 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 security deposit is in the form of a letter of credit, landlord must comply strictly with issuing bank presentation requirements.

  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.

- Lease termination agreements – efficient means of termination of tenancy by mutual agreement of landlord and tenant, but 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) in the event of a subsequent tenant bankruptcy filing

- Tenant guarantor – may be sued by landlord for recovery of lease obligations; tenant bankruptcy does not impair suit against guarantor

  NOTE: If guarantor is bankrupt, landlord claim will be limited by the federal Bankruptcy Code cap on claims against the tenant (see below). If the guarantor is not bankrupt, the Bankruptcy Code cap on claims will not generally apply to the guarantor, although there are cases to the contrary.

<u>Tenant Eviction Proceedings</u>

- Governed by state statutory requirements

- Following notice and cure periods required by lease (or statute in the case of tenancies at will), suits are typically bifurcated as a suit for possession and a suit for recovery of rent, to avoid delay in recovery of possession and reletting while cross claims for rent and damages are separately pursued

Tenant Bankruptcy

- Automatic stay invoked upon tenant bankruptcy filing – landlord may not send default notices, pursue default remedies (such as seek eviction or possession, apply security deposit) under lease after tenant filing without permission from the bankruptcy court

  NOTE: Termination of lease prior to tenant bankruptcy filing gives landlord much greater control over premises through ability to take action to recover possession, notwithstanding filing (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

- Rental obligations during period after filing and prior to rejection of lease – must be performed by tenant, although performance may be extended by Bankruptcy Court for up to 60 days after filing; if not performed, landlord may seek Bankruptcy Court relief to force performance, grant relief from stay to terminate lease and evict tenant, or force tenant to decide to assume or reject the lease

- 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), all of which would be treated as a general unsecured claim; landlord may be entitled to better treatment of claims for rent arising after the filing but prior to rejection

  NOTE: Cap does not assure payment, but sets limits on landlord recovery.

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

- Assumption of lease by tenant is allowed with Bankruptcy Court permission, but tenant defaults must be cured as a condition of assumption

- Assignment of lease after assumption is generally permitted by Bankruptcy Courts, overriding any lease anti-assignment provisions, provided that all tenant defaults are cured and assignee gives adequate assurance of future performance; assignee may benefit from the "cleansing" effect of an assignment via bankruptcy, with prior liens extinguished

- Rejection of lease by tenant results in lease termination as of filing date, ending obligation to pay rent and perform lease covenants, subject to landlord's recovery of capped claim

Landlord Financial Distress

- Effect of mortgage foreclosure upon lease – depends upon state law (including whether foreclosure automatically wipes out subsequent leases, ability of mortgagee to subordinate mortgage to leases prior to foreclosure, ability of mortgagee to selectively identify leases to be preserved or extinguished by foreclosure), terms of lease, and existence or absence of subordination, non-disturbance and attornment agreement

- Mortgagee considerations prior to recognition of a lease:
  - Size of tenant in relation to the property (larger tenants will likely have received an SNDA)
  - Economic terms, including fixed rent and items included and excluded from additional rent (e.g., taxes, operating expenses, ordinary and capital repairs)
  - Length of remaining term and any options to extend
  - Security deposits and tenant creditworthiness
  - Tenant first refusal rights or expansion rights for additional space, and options to purchase
  - Landlord obligations to fund or perform tenant improvements
  - Tenant assignment and subletting rights, including degree of landlord approval rights and profit sharing

Landlord Bankruptcy

- Bankruptcy Code does not impose deadline for landlord assumption or rejection of lease
- If the landlord rejects the lease, tenant has two (2) options:
  - Tenant may treat the lease as terminated, or
  - Tenant may retain its rights under the lease, including the rights to possession, use, quiet enjoyment, and subletting and assignment, both for the original term and any properly exercised renewal or extension of the term
- 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

Acquisition Alternatives

- Acquisition of single loan – may be in context of exercise by junior/mezzanine lender of rights under intercreditor agreement, workout by investor partner of joint venture borrower, or investment strategy to acquire a particular mortgaged property
  - 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 – may be exit strategy for institution needing to raise capital or rebalance portfolio, or venture fund needing to return capital to investors; conversely, acquisition of loan portfolio may be a promising investment opportunity for private equity
- Commercial mortgage backed securities – particular focus of national economic crisis; unwinding of complex certificate holder, trustee, master servicer, special servicer and associated financing relationships makes workout of individual mortgage collateral extremely difficult

  NOTE: This topic is beyond the scope of this outline; same general principles at the property level apply, but resolution of CMBS problems involve complex additional securities and tax issues, including the potential loss of favorable "pass through" treatment for mortgage holders formed as REMICs or grantor trusts

- Loan sales transactions are likely to accelerate over the next several years, given the large volume of commercial mortgage loans maturing in 2009/2010 as to which takeout financing either will be unavailable or available only on commercially unattractive terms

Tax Concerns

- Restructuring of loan after purchase at discounted price can cause purchaser to realize significant "phantom" gain
- Simultaneous purchase and restructuring of debt can avoid tax problem, but may be difficult to accomplish
- Purchase of debt by party treated as related to debtor under complex tax rules can trigger cancellation of debt income for debtor

Due Diligence Checklist for Loan Acquisition

- Due diligence is key to underwriting of the value of a mortgage loan, whether in an individual or portfolio context
- Loan document review
    - Conformance with purported business terms – original principal amount, interest rate, amortization, maturity date, required reserves, prepayment restrictions, assumption guidelines, recourse provisions, guarantees (loan payment, non-recourse carve-outs, environmental, springing recourse for voluntary bankruptcy, etc.)
    - Completeness of documentation – originals of all loan documents, especially note and guaranty; at least copies of recorded documents and any other unrecorded documents
- Status of post-closing obligations and arrangements
    - Payment of real estate taxes and other municipal liens – key financial issue, as these will take priority over mortgage lien
    - Insurance coverages – should have current certificates from borrower; may also need insurance certificates from tenants
    - Establishment of reserves; status of release of reserves upon satisfaction of post-closing covenants
    - Completion of improvements/repairs to mortgaged property

   - Satisfaction of regulatory requirements – payment/performance of mitigation obligations for development projects, completion of environmental remediation (soils/underground storage tanks, asbestos, etc.); ongoing reporting obligations for special purpose operations such as life science laboratories or industrial facilities; status of operating permits
   - Status of any lock-box arrangements
- Title/survey
   - Review original title policy, obtain updating endorsement to identify any new issues (junior mortgages, unpaid real estate taxes and betterments, mechanics liens, attachments common in a distress situation)
   - Consider survey update, although will depend upon level of investment in due diligence; more important in development projects; site access could be an issue if in an adversarial situation with borrower
- Lease matters
   - Availability of copies of current leases
   - Status and custody of security deposits – cash; letter of credit
   - Current insurance certificates
   - Tenant financials
   - Leasing/marketing plan
- Contract matters
   - Availability of copies of current contracts
   - Property management – consider ability to terminate absent foreclosure; affiliate of borrower or third party provider
   - Service contracts – same issue re termination; status; payables
- Property condition
   - Environmental assessment – review file for report obtained at time of loan closing; update for current transaction

- Physical condition report – review existing report and update report based upon current inspection
- Regulatory review – check local building department for any outstanding violations and copy of existing certificate of occupancy; in the context of a development project, review records of other local boards involved in the entitlement process

- Entity selection for acquiring entity – use of single purpose entity provides liability protection; alternatives for credit required for transaction include letters of credit for post-closing liabilities, guaranty from credit-worthy affiliate for specific liabilities; 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

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 (assess required consents at outset of transaction if a multi-party lender)
  - 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 – title, survey, environmental assessments, property condition reports, opinions, leases, contracts
- Status of any litigation
- Status of any tenant defaults, litigation or bankruptcy
- Existence of any brokerage arrangements and responsibility for commissions

NOTE: As in the case of a purchase and sale agreement for real estate, 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

- Conditions to closing
  - Continued accuracy of representations and warranties
  - Absence of borrower/guarantor bankruptcy or new litigation
  - Absence of material adverse change, including financial status of any credit tenants
  - Delivery of required documents (include in default/remedies provision of assignment agreement as well; consider damages and specific performance remedies)
- Covenants as to confidentiality of transaction and agreement not to market during pendency of agreement
- Closing deliveries
  - Purchase price and closing costs (escrow, title insurance, brokerage)
  - Original promissory note will be transferred with an endorsement marked "WITHOUT RECOURSE" to the assignor, to confirm that the assignor has no liability under the note
  - Assignment instrument for remaining loan documents – may have separate assignment for record documents such as mortgage and assignment of leases in addition to general instrument of assignment

- Due diligence materials
- Authority documentation (consents, corporate votes, legal existence certificates, etc.)
- FIRPTA affidavit
- Letter to borrower advising of transfer of loan from assignor to assignee
- Certificate to update representations and warranties
- Settlement statement

Selected Bankruptcy Issues Affecting Distressed Real Estate

Primary Proceedings under US Bankruptcy Code - Chapter 7 Liquidation and Chapter 11 Reorganization

- Chapter 7 liquidation - the debtor's operations generally cease as of the day the bankruptcy is filed; a bankruptcy trustee is appointed to oversee the wind-down and liquidation of the debtor's assets, the calculation of claims against the debtor, and the distribution of the proceeds of those assets toward payment of those claims in accordance with the "waterfall" of priority established by the Bankruptcy Code
- Chapter 11 reorganization - the debtor's operations generally continue notwithstanding the bankruptcy filing, the company acts as a "debtor-in-possession" and essentially serves as its own bankruptcy trustee
    - The company proposes its own Chapter 11 plan of reorganization that contains the rules for calculating claims against it and for how, when, to what extent and in what order those claims will be paid
- Although Chapter 7 and Chapter 11 cases can be very different from one another, they share common themes
    - A bankruptcy isolates pre-bankruptcy obligations of the company and generally puts them "on hold" for the duration of the bankruptcy case - creditors generally cannot collect current payment of amounts that became due prior to the bankruptcy filing
    - A bankruptcy can reduce the amounts owed by the company for the pre-bankruptcy period, either because only a partial payment is available in a Chapter 7 liquidation or because only a partial payment is called for in the company's Chapter 11 plan of reorganization

Bankruptcy Sales

- Debtors in possession may continue to operate their business, including sales of assets, such as inventory, so long as such sales are conducted in the ordinary course of business

- However, debtors (and trustees in Chapter 7 cases) may also conduct sales outside the ordinary course of business, but they require a hearing and bankruptcy court approval

- Sales outside the ordinary course of business, which can include dispositions of specific assets or substantially all of the assets of the debtor, and which can include personal property and real property, are completed under Section 363[1]

- Section 363 sales provide for the sale of such assets "free and clear of any interest in such property," meaning that liens (including mortgages) are cut off - a Section 363 sale may also cut off other claims such as successor liability, ERISA claims, product liability claims, setoff rights and rights of tenants

  NOTE: Orders entered by the Bankruptcy Court approving such sales typically provide that the interests which the property is sold free and clear of attach to the proceeds of the sale.

  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 Sec. 363, and risk the sale being challenged as a "sub rosa" plan of reorganization, or to complete the sale through an actual plan of reorganization (see discussion of Reorganization Plans, below), which generally takes more time to complete.

- Secured lenders and mortgage holders may "credit bid" their debt under Sec. 363(k), and offset their secured claim or mortgage debt against the purchase price

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[1] All statutory references in this outline are to the US Bankruptcy Code.

- Section 363 sales are typically conducted through an "auction" type of process – there are opportunities for stalking horse bidders to obtain some bidder protections, such as breakup fees and the ability to influence the bidding procedures to be used (including the schedule for conducting diligence, submitting bids and closing on the sale)

- 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

- Automatic Stay Generally. 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

  NOTE: Violation of the automatic stay is a serious offense.

- Exceptions to the Automatic Stay. There are a number of exceptions to the automatic stay which are embodied in Sec. 362(b), including any action by a landlord against the debtor under a nonresidential real property lease that has terminated before the commencement or during the bankruptcy (Sec. 362(b)(10))

  NOTE: In determining the parties' rights in bankruptcy, a key issue is whether a lease has been properly terminated before filing, even if possession has not been obtained by the landlord. If a lease has been properly terminated, a landlord may continue to pursue possession, even without relief from the automatic stay.

- Motion for Relief from the Automatic Stay. A lender or landlord may seek relief from stay (Sec. 362(d)):

- "For cause", including a lack of adequate protection of such party's interest in property (Sec. 362(d)(1))

    - The Bankruptcy Code does not enumerate what constitutes "for cause", but the following are some possible examples: failure to maintain and preserve collateral (including failure to insure and failure to keep collateral free of liens), 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))

NOTE: With respect to the issue of lack of equity in the property, a valuation is needed to show that the value does not exceed the debts secured by the property; for secured creditors, there is some strategizing that must go into this issue as they are only entitled to payments of accruing interest and attorney's fees if their claims are oversecured.

- 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 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

    - If intent on pursuing relief from stay on this basis, a lender should commence action as soon as practicable

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
- Loan workouts and lease terminations can be subject to challenge as fraudulent transfers if the borrower/tenant gives something to the lender/landlord such as fees or collateral but also such as a deed in lieu of foreclosure or lease termination agreement
- A foreclosure sale does not need to meet the "reasonably equivalent value" test if done in accordance with state law, although a "too low" price may suggest the sale was not commercially reasonable

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 transfers 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 date; "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.

Reorganization Plans

- Timing/Who Can File – the debtor has the exclusive right to file a plan for the first 120 days after the commencement of the bankruptcy case, or such other time as may be extended (or reduced) by the bankruptcy court, provided that the time to file a plan may be extended by the court to a date no later than 18 months after the filing of the bankruptcy case; if such period expires without a plan being filed, a creditor, committee or other party in interest may file a plan

- Postpetition Interest and Attorney's Fees Under Section 506(b) – to the extent that a claim is secured by property the value of which is greater than the amount of the claim, the holder of the claim is entitled to recover interest on such claim and reasonable fees and expenses as provided for under the applicable agreement

- Confirmation of a Plan – the debtor will often seek to write down the mortgage to the value of the property and stretch out payments to the mortgagee over a longer period of time or at a lower interest rate (or both); a plan can be confirmed over a mortgagee's objection through a "cramdown" which complies with the absolute priority rule

    - Cramdowns – Generally, plans of reorganization must be approved by all classes of creditors, but a cramdown may occur when at least one impaired class has approved (by more than 2/3 in dollar amount and more than 1/2 in number) the plan of reorganization, even if another class (such as a mortgagee) actually rejects the plan. 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 the property and is entitled to deferred cash payments with a present value of at least the mortgagee's interest in the collateral – note that the discount rate for determining present value may well be less than the mortgage loan interest rate
        - Sale of the collateral, subject to the mortgagee's lien (with mortgagee generally able to credit bid at such sale)

        - Mortgagee receiving 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

- Right to Reinstate Accelerated Loan - pursuant to Bankruptcy Code Section 1124(2), an accelerated loan may be cured and reinstated as part of a plan of reorganization

Special Strategic Considerations for Undersecured Mortgagees

- Before the conclusion of the hearing to establish the voting procedures for the Chapter 11 reorganization plan, an undersecured mortgagee must decide under Section 1111(b) whether to treat its entire claim as secured or to treat it as two claims, (a) a secured claim up to the value of the collateral and (b) a deficiency claim in the amount of any unsecured claim

    - The principal benefit of electing to treat the entire claim as secured is that the deferred cash payments to the mortgagee in any reorganization plan must at least equal the present value of the full claim – without such an election they must only equal the present value of the collateral, with the lender being treated as an unsecured creditor for the deficiency
    - The principal downside of making such an election is that the mortgagee loses its right to vote its deficiency claim as a member of the unsecured creditor class
    - Mortgagees often consider electing to treat the entire claim as secured when they expect the value of the property to appreciate and the property to be sold or refinanced within a short period of time, or in the case where their deficiency claim is small and unlikely to dominate the unsecured creditor class

Bankruptcy of Tenant

- The Bankruptcy Code provides a tenant/debtor with a 120-day window to make a decision to assume or reject a lease for non-residential real property
- The 120 day window may be extended for a period of up to 90 days (for a total of 210 days) upon a showing of "cause" - the period may be extended beyond the 210 days only upon prior written consent of the landlord
- During the time period prior to assumption or rejection, the tenant must continue performing its obligations under the lease, such as paying rent, taxes and common area obligations; the bankruptcy court may extend the time for performance of obligations arising within the first 60 days after filing, but the time for performance of such obligation shall not be extended beyond the 60 day window
- If the tenant fails to pay or perform any such obligations, the landlord may bring such failure to the attention of the Bankruptcy Court by motion, and seek relief such as forcing the tenant to perform, obtaining relief from stay to terminate the lease and evict (highly unlikely unless serious or multiple post-petition breaches) or forcing the debtor to decide whether to assume or reject the lease
- In order to assume the lease, the tenant must cure any defaults
- The tenant may also assume and assign the lease to a third party (which is a valuable right if, for example, the lease is a below market lease), provided that all defaults are cured and the assignee provides adequate assurance of its ability to perform under the lease in the future
    - This right to assign can be employed as part of an acquisition of assets out of a pre-packaged bankruptcy, allowing the acquirer to select the specific leases it seeks to acquire
    - The bankruptcy process itself affords an opportunity to notify the landlord of the planned assumption and assignment, and to compel the landlord to notify the tenant and the assignee if the landlord believes there are defaults or cure costs in addition to those proposed by the tenant and assignee to be resolved as a condition to assumption and assignment - if the landlord receives proper notice and fails to

raise any other defaults or cure costs known to (or, perhaps, knowable by) the landlord, the landlord may be estopped from later raising them against the assignee

NOTE: Section 365(f)(1) generally overrides anti-assignment provisions in leases (which may include "constructive" anti-assignment provisions in leases which overly narrowly limit the use of the premises), however, reasonable and limited use restrictions (e.g. to ensure appropriate merchandise mixes at shopping centers) may be defensible.

NOTE: The Section 365 assignment process is often made subject to competitive bidding, especially when a lease assignment is part of a larger asset sale transaction. Bankruptcy courts will try to maximize the price paid by the assignee by requiring notice of the assignment to other potential assignees and, given sufficient interest, by holding an auction. In some cases, the initially proposed assignee - the "stalking horse" bidder - will negotiate a "break-up fee" and an expense reimbursement amount if the lease is ultimately assigned to a different entity at a higher price. To accommodate that potential fee and reimbursement, the bidding rules established by the bankruptcy court will require that any additional bid for the lease is greater than the "stalking horse" bid by at least the amount of the fee and reimbursement, plus some incremental "topping" amount.

- The tenant may decide to reject the lease, in which event the lease will be treated as effectively terminated as of the filing date (ending the debtor's obligation to pay rent and other amounts going forward as of the date of rejection, but subject to the landlord's right to collect damages as discussed below)
  - If a lease is rejected, the landlord will be entitled to damages under the lease in accordance with applicable state law, except that under Section 502(b)(6) of the Bankruptcy Code, the amount of damages is "capped" at (i) the unpaid amounts of all rent which is due plus (ii) an amount for ongoing rent which would have been due after the rejection date, but such amount is limited to the greater of 1 year's rent reserved or 15% of the rent reserved (not to exceed 3 years) – it is important to note that this is just a cap; the landlord is not automatically entitled to these damages, and in some cases it will not be entitled to any claim at all (for example,

if it is able to re-let the space at a rent that will cover all of its losses resulting from rejection)

- There is a divergence of opinion on the applicability of the cap to costs for removing a tenant's property from the premises, or cleaning up the premises due to environmental issues, or making the premises suitable for re-letting, the resolution of which issues often hinge on whether or not the obligations were related to the termination of the lease (in which case any claim by the landlord will be deemed an unsecured claim) or a separately arising obligation of tenant (in which case the landlord may be entitled to a better position in bankruptcy)

- Letters of Credit vs. Cash Security Deposits
    - Cash security deposits held by a landlord are most often treated as property of the debtor and are therefore subject to the protections of the automatic stay - the landlord cannot simply apply the security deposit against the amount owed under the lease without getting relief from the automatic stay; most courts will require the landlord to apply the security deposit against "capped claims"
    - Generally, due to the "independence principle," landlords may apply letters of credit without the need to get relief from the automatic stay, although it is best practice to obtain relief in order to avoid any possible claim that such action violates the automatic stay, particularly when the lease treats the letter of credit as a "security deposit" - while courts diverge on whether the proceeds of letters of credit should be applied to the capped claim only (see above) or allowed to be used to reduce the landlord's actual damages, where the lease treats the letter of credit more like a security deposit, the application to the capped claim is the more likely result
- Claims against lease guarantors
    - If the guarantor is not in bankruptcy, absent a specific order of the bankruptcy court extending the automatic stay to a guarantor (which would be unusual), the landlord may pursue a guarantor independently for amounts owed under the lease, and the claims against a guarantor are generally not limited by the Section 502(b)(6) cap (although there are cases to the contrary)
    - However, courts have held that where the guarantor is in bankruptcy, the claims against the debtor-guarantor are limited by the Section 502(b)(6) cap

Bankruptcy of Landlord

- No Bankruptcy Code time limits for assumption, rejection or assumption and assignment of leases
- Irrespective of a landlord's election, a tenant has significant protections – specifically if a landlord rejects an unexpired lease of real property, the tenant has two options:
  - If the rejection amounts to a breach that would entitle the tenant under the lease to treat the lease as terminated, then the tenant may treat the lease as terminated
  - The tenant may elect to retain its rights under the lease, including rights of use, possession, quiet enjoyment, subletting or assignment, that relate to the real property for the balance of the term of such lease, and for any renewal or extension to the extent they are available under applicable non-bankruptcy law
    - If the tenant retains its rights, then the tenant may offset against the rent reserved the value of any damages caused by the landlord's nonperformance after the rejection of any obligation under the lease

    NOTE: While the rejection of such a lease by a landlord results in the lease being treated as breached, the Bankruptcy Code specifically provides that the election of the tenant to retain its rights under a lease of real property in a shopping center does not affect the enforceability of any provision in the lease pertaining to "radius, location, use, exclusivity or tenant mix or balance"

    - If the rental rate is low, this latter option will likely be quite appealing in a single-tenant building with limited landlord obligations; in a multi-tenant property which is actively managed by the landlord, offset rights might not be a practicable remedy for a tenant if common areas are not maintained, security is not provided, etc.

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