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Workout in the Age of Capital Stacks

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This paper identifies the different responses available to a mortgage lender faced with its borrower's default; the preliminary due diligence that should be undertaken before responding; confirming the nature as well as the cause of the default; the prophylatic steps to be taken when initially communicating with the borrower; reviewing the loan documents and any intercreditor or third party servicing arrangements; updating of due diligence and third party reports from origination; understand the inherent risks of initially pursing foreclosure or workout and then switching; pre-workout agreements; loan workout alternatives and documentation; different types of state foreclosure procedures; protecting the rents during the foreclosure or workout; suits on the note or any guaranty and their respective risks; deeds in lieu of foreclosure and its risks; dealing with environmental issues; borrower and guarantor defenses and claims; and the risks to lender of borrower bankruptcy, loan re-characterization and other lender liability claims by borrowers, guarantors and other co-lenders or investors in the loan, as well as guidance on how lender can best avoid, or at least mitigate, these risks.

To Foreclose or to Workout: That is the Question

Joseph P. Forte

Introduction

In the next downturn of the real estate market, real estate professionals will be required to devote more of their time and direct most of their efforts to working out their borrower's troubled properties in an attempt to salvage a problem loan. Yet, whatever the cause of a loan failure, a successful workout is possible only after a lender undertakes a full and frank analysis of the facts and circumstances of its credit and collateral and an honest and complete assessment of its legal alternatives and their consequences. While creativity and motivation are very important, a workout can only succeed if based on reality and sober decision making. Workouts will often require lenders to consider and grant concessions and adopt investment structures that a lender would not ordinarily consider acceptable in the usual course of the origination and administration of its loan investments. Considerations in an upcycle real estate market do not work in the downcycle. The desire for rate of return on investment gives way to concern for recovery of loan principal.

The primary objective of any lender's workout strategy should be to maximize the recovery of its investment by realization on its collateral in the most cost effective and time efficient manner in the context of the then current economic circumstances. While there are always many variables and probably several contributing causes to any loan default, there is usually one paramount cause which must be considered and dealt with if the restructuring of the loan is to succeed.

1. Reasons For Default

It is essential to the success of the workout that the underlying cause of the monetary or non-monetary default be investigated and determined by a lender. A lender should automatically conduct preliminary due diligence before deciding to undertake the workout of a problem loan. Only after the actual reason for the default is established can a lender make a reasonable decision whether to attempt a workout or even which enforcement alternative it should pursue. Notwithstanding the numerous borrower (or lending officer) excuses, the root cause must be isolated before a lender can properly assess whether a proposed restructuring will actually address what is "wrong" with the borrower's project and consequently with the loan. Obviously, many of these causes will overlap or interrelate. Applying remedial measures to the wrong issue is a sure road to failure and its consequences. Most defaults fall into one of the following categories of proximate causes:

Borrower – Before taking any action, a lender should first consider its borrower — its credit as well as its performance — on the loan and its project to date. An untrustworthy borrower should probably not be relied upon to live up to new terms any better than it performed under the old. Consideration of the borrower's (as well as its principal's) commitments of time and money to other projects and properties should be of paramount concern. A borrower or guarantor (or their respective principals) default or threatened default under another problem loan is an indication that its focus may not be on a lender's project alone. A single asset entity should be viewed differently from a multi-property developer. The risk of bankruptcy — voluntary or involuntary — must be assessed before grant of any concessions. Finally, a lender should assure itself that the borrower is a viable entity, i.e., that the principals are in agreement on the course to be taken, and that no serious internal impediments to the workout exist. The capacity or willingness of the borrower to contribute additional capital from its own resources or ability to attract new investors or satisfy additional lenders will be critical to the financial success of a troubled venture.

Management – As the 2008 financial crisis demonstrated, a lender should not presume that a residential developer can successfully undertake and complete a commercial project and vice versa. A careful evaluation should be made of the borrower's ability and capacity to continue to manage the project after a restructuring. Bringing the proper management expertise to bear can improve a project's chances of recovery. Because of the legal risks associated with a lender's "control" of the borrower, care should be taken in this area to simply approve of a borrower's actions, but never to direct them. If a borrower is required to choose new management company or managing member of borrower before a lender will commit to restructure, a lender should offer several alternatives that would be acceptable to lender if chosen by borrower.

Project – Having decided to work with its borrower, a lender should then investigate the project that it underwrote at the origination of the loan. For a construction loan, review of the work in place to date and the sufficiency of the undisbursed loan balance to complete construction should be analyzed. For existing properties, a survey of the physical condition of the property and a cost study of necessary repairs and delayed maintenance expense should be a factor in the restructuring equation. An engineering study may also be necessary, and for a construction loan essential, to a proper understanding of the physical condition of the collateral.

Trouble in the Capital Stack – Without any default in the mortgage loan,[1] the existence of a monetary or non-monetary default(s) in any subordinate debt encumbering the mortgaged property, or secured by a pledged equity interest in the owner of the borrower or in its vertical tier ownership entries, may disrupt the cash flow servicing the mortgage debt, otherwise disrupt the operation or management of the mortgaged property or lead to a threat of a UCC foreclosure of the equity membership interests by the subordinate debt holder, eroding the working relationship of the owners or lenders in the capital stack and leading to “tranche warfare” within the ownership or lending classes.

Market – Once a lender reassesses its borrower and collateral, it must realistically reevaluate the existing market. Given the impact the internet has had on the use of property, e.g., e-commerce’s economic disruption of retail and its impetus to warehouse and distribution centers, Airbnb's infiltration of the hotel sector, WeWork's direct competition with office, and the repurposing of declining retail shopping centers as urgent care facilities, government offices, community colleges, etc., a feasibility study as well as an appraisal of the property should be conducted to establish the present value of the project. A determination of value in the current market is essential for a lender

[1] For purposes of this article, a mortgage includes a mortgage deed, a deed of trust, a trust deed, a deed to secure debt as well as any other real estate security instrument no matter how it is denoted in its state.

to decide its initial strategy with its borrower. Market acceptance and absorption time of the project or liquidation value of the current or contemplated use are also of importance.

Regulatory Constraints – Limitations on a lender's ability to continue to fund a staged advance loan may cause a default, but may also limit a lender's ability to make protective advances, or otherwise deal with a troubled property. Loan-to-value limits, loan to one borrower limits and other statutory, regulatory or contractual investment restraints may severely hamper a lender and limit its available options. Implicit salvage powers, which are available to unregulated lenders and certain regulated institutions, are not available to all regulated lenders. The regulatory limitations on a lender may not relieve lender of its contractual obligations for which a lender may be liable to its borrower or guarantor for damages.

General Economic Conditions – Unrelated to the borrower or a particular project, the general economy of a locale or region, such as increased unemployment or an economic downturn, may adversely affect real estate values. This is clearly beyond the control of borrower or lender and therefore may require extraordinary measures by a lender to resolve its troubled loan.

Too Much Leverage – Prior to the 2008 financial crisis there was clearly too much capital looking to finance too few new transactions, which lead to overleveraged properties as well as loans that should never have been made but for the crush of competition by lenders for product. The specter of ever increasing values and downcycle amnesia often make real estate the fashionable investment. Too many speculative investments may be made without proper or prudent underwriting. Loans must be reviewed and re-underwritten at the time of the default to determine if they still make any economic sense. In a downcycle pro formas do not prove true; the investment requires a re-evaluation to decide if any workout (other than forced liquidation) even makes economic sense.

2. Lenders and loan administration

Once it has established the cause of its borrower's default, a lender usually has a number of different courses of action. Before making its decision, however, a lender should analyze its available legal remedies against the contractual workout alternatives to decide which will maximize its realization with the least risk and cost to the lender. Retaining a commercial real estate workout specialist may be the appropriate first step after default for those lenders lacking the expertise, experience or appetite to acquire property in default, leaving them more susceptible to accommodating a borrower and working out the loan.

Whole Loans – Today not all mortgage loans are traditional “whole” mortgage loans on a property evidenced by a single promissory note and serviced by a lender or its designated third party servicer throughout the life of a performing and non-performing loan.

Participated Loans – A loan originated for a participation arrangement among lenders is similar to the typical whole loan as it is evidenced by a single note and mortgage and serviced by the holder of the note (lead lender) or its designated third party servicer. As the interest of the participants is a contractual undivided interest in the whole loan, evidenced by a participation certificate issued by the lead lender pursuant to the agreement among the participants, participants have no privity with the borrower. The ownership interests of the participants can be either pari passu or senior-subordinate priority in payment and liquidation or in liquidation only. That agreement also expressly limits the power and authority of the lead lender with respect to certain major workout or enforcement decisions, which require the approval of a set percentage, or all, of the participants.

Syndicated Loans – Commercial mortgage loans originated for syndication arrangements will have multiple split notes, which may be either pari passu (A/A or syndicated loan) or senior-junior (A/B) with priority in payment and liquidating or liquidation only, and usually one mortgage. The servicing of these split notes is performed by a designated party (either a syndicated member or a third party servicer) pursuant to the terms of the syndication agreement. The syndication agent or its third party servicer's authority and power to conduct workouts will be limited by the express terms of the syndication agreement governing the administration of performing and a non performing loans, especially in respect of certain major workout or enforcement decisions which will require approval of a set percentage of, or all, syndicate members.

Co-Lending Arrangements – Commercial mortgage loans originated for co-lending (or Club) arrangements will have multiple split notes, which may be either pari passu (A/A or syndicated loan) or senior-junior (A/B) with priority in payment and liquidating or liquidation only. The servicing of these split notes is performed by a designated party (either a co-lender or a third party servicer) pursuant to the co-lending agreement. The servicer's authority and power to conduct workouts will be limited by express terms of the co-lending agreement governing the administration of a performing and a non performing loan. Each co-lending noteholder will have its own mortgage, of coordinate lien and equal priority, in the amount of its percentage share of the debt.

Securitized Loans – While most loans originated for conduits are whole loans, large loans and loans to single borrower (with multiple properties) or on a single asset (a "trophy" property) are often evidenced by multiple split notes which may be pari passu (A/A) or senior-junior (A/B). A Notes will be deposited in several different securitizations with the servicer of the first securitization acting as servicer for all A Notes in the different CMBS pools. With A/B Notes, the A Note will be deposited in a securitization; the B Note will not be deposited, but will be held outside of the CMBS Trust.

Servicing Standard – All loan administration for performing and non-performing mortgage loans, by lenders or third party servicers, other than portfolio lenders servicing their own mortgage loans, are traditionally subject to a contractual servicing standard governing their obligations.

Non Securitized Loans – All lenders and third party servicers of whole loans, participation arrangements, syndicated loans, and co-lending arrangements are usually subject to a similar standard governing the performance of their contractual obligations with respect to performing and non-performing loans which their agreements usually provide that they:

> must service the loan as they would loans and assets for their own account, or those of a third party, whichever is higher, for a loan of similar size and priority covering the same type of property

which is often supplemented with the usual customary, as well as bespoke, conditions and limitations with respect to certain major workout or enforcement decisions which may require approval of all, and/or a set percentage of, the holders of any interest in the loan pursuant to their agreement.

Securitized Loans – The servicing of mortgage loans to be deposited in a CMBS Trust is governed by the Trust's Pooling and Servicing Agreement (PSA). For each securitization, there will be several parties engaged who will be involved in any workout or enforcement of a mortgage loan:

- the Trustee holds legal record title to the mortgages on behalf of the certificateholders of the CMBS Trust;

- the Master Servicer handles the day-to-day administration of the mortgage loans (including any subordinate interests in the loans) and makes protective advances for the mortgages;

- the Special Servicer handles the servicing of defaulted loans and initiates workouts and foreclosures as well as other default resolution strategies (including related interests held outside the Trust) and is the sole CMBS Trust contact with the defaulting borrower; and

- the Controlling Certificateholder, is usually the most subordinate certificateholder subject to certain class loss thresholds, and in absence of a B note holder or subordinate participation holder in the mortgage loan, can replace the special servicer and approve most major decisions by special servicer regarding workouts and default resolution strategies.

All the foregoing parties are subject to the Servicing Standard in the PSA in the performance of their contractual obligations which usually provides that the Master and the Special Servicer:

- use the same standard that they use to service their own loans and assets, or those of a third party, whichever is higher with a view to: the timely collection of all mortgage loan payments for, and the maximization of the "net present value" of, such mortgage loans;

- will act in good faith and use reasonable judgment in accordance with applicable law, the terms of the PSA, the terms of the mortgage loan documents and the Servicing Standard;

- must disregard certain conflicts of interest including: any relationship with borrower, their ownership of any related CMBS certificates or other interests related to the mortgaged property, its obligation to make advances, its rights to collect servicing fees or other compensation, the ownership of servicing of any other loans or properties outside the pool; and must service loans (and interests held outside the CMBS Trust) for the benefit of each of the holder as a collective whole.

Mezzanine Loans – Notwithstanding the existence of intercreditor agreements between mortgage lenders and related mezzanine lenders governing their relationship, the Master and Special Servicer do not service mezzanine loans related to the deposited mortgages.

Workout Fees – Another significant difference in a workout or enforcement conducted by a Special Servicer as opposed to other third party servicers is that Special Servicers are entitled to significant loan workout fees and liquidation fees from the Trust, which have been very controversial with borrower as well as CMBS investors, while traditional third party servicers collect standard market fees and their expenses in the workout from, or through, the lender who may or may not collect it from the borrower.

3. Response To Default

To protect the availability of its collateral for realization and to avoid liability to others, a lender should formalize a uniform series of steps in response to, but before reacting to, a default on its mortgage loan. Steps to be considered include:

Review Loan Documents And Servicing File – The first and most important step is to obtain the original loan documents and servicing file for careful review and analysis. A lender should determine its documentary rights, clarify circumstances of the default and review its response to date. Regulatory guidelines should be considered and observed in the review and analysis. The loan and servicing files should be analyzed to assure that no course of conduct, or oral or written communication, has granted any indulgence or forbearance to the borrower or its principals.

Ascertain Loan Parties – A lender should determine from its records if the loan is subject to a loan participation, co-lending arrangement, syndication, a mortgage loan purchase agreement or has been pledged to a third party as security under a loan warehouse agreement or repo transaction, deposited in a collateralized loan obligation transaction, or otherwise subject to an intercreditor agreement with the holder of a subordinate mortgage or a mezzanine loan or other financing related to the mortgage loan (the counterparties to such arrangements collectively, "Other Loan Parties").

Send Default Notices To Borrower, Guarantors, Junior Lienors and Other Loan Parties – Notwithstanding that the documents do not require the giving of default notices, a lender should give notices to the borrower, any guarantor and any junior lienors as well as any Other Loan Parties entitled to notice in accordance with their respective agreements. Consider allowing a cure period, even if not provided for expressly in the documents, for guarantors, junior lienors, Other Loan Parties or even the borrower, before the loan is accelerated. The notices should set definite amounts and time limits for curing the event of default.

Retain Independent Specialists – Depending on the nature of the loan and the type of property securing the loan, it may be very helpful to retain third party specialists to assist in any workout, restructure or foreclosure. These include:

- *Workout Specialist*
- *Industry Specialist*
- *Appraiser*
- *Construction Inspector/Property Condition Engineer*
- *Independent Accountants*
- *Independent Counsel*
- *Environmental Consultant*

Access to the property and operational information may be problematic, but in no event should a lender, or its agent, or any third party contractor interfere with, or direct the operation of, or exercise any dominion or control over, the borrower's property.

Obtain Reports – Upon selecting and retaining its specialists, a lender should obtain relevant analyses and assessments as a prerequisite to making a determination of how it should proceed (or not proceed) to realize upon its collateral. Although a lender may retain a specialist, it may need to rely on a negotiated forbearance period, "current" borrower consent, or the cooperation of a court-appointed receiver to obtain the updated information that needs such as:

- *Updated Appraisal*
- *Updated Property Condition Report*
- *Environmental Site Assessment and existing*
- *Environmental Insurance Policy, if any*
- *Updated Title Search*
- *Current borrower and guarantor financials*

Review of Leases and Contracts – Given that the mortgaged property is usually income producing, it is critical that a lender review and assess the status of the property , any management agreement, and all service contracts; actual cash flow of the property and whether it covers debt service, property taxes, management and other service contracts and operational expenses; and the loan reserves for capital expenditures and other expenses. This will allow lender to make a determination upon enforcement as to which leases to retain, and if subordinate, which leases to retain or cut off in the foreclosure, as well as what lender will be facing if it takes a deed in lieu of foreclosure.

If a loan encumbers a leasehold estate, a lender must review the ground lease and the ground rent, including confirming existence of the customary mortgagee leasehold protective provisions and the remaining term and any extensions as well as considering the financial risks of potential ground rent increases.

4. Workout vs. Enforcement Risks

Before ending workout negotiations or calling a default under a workout agreement and before terminating a foreclosure and entering into workout negotiations or a workout agreement, a lender must be cognizant of the potential risks inherent in such reversal of strategy and take very specific and deliberate steps to avoid some avoidable, but catastrophic consequences of seemingly innocuous actions:

Voiding Foreclosure after Completion – Before commencing or ending the forbearance of, and re-instituting, a foreclosure - judicial or non judicial - of a mortgage that has been the subject of workout negotiations or a workout agreement, lender should confirm in writing to borrower, guarantor, junior lienors or any Other Loan Parties entitled to notice that the workout negotiations have been terminated or that they are in default of the workout agreement and that the lender will be commencing or reinstating foreclosure of the mortgage. (A state court of last resort required a lender to start its foreclosure over again based on the borrower's defense that the lender did not inform it that the workout had terminated before commencing foreclosure.)

Statute of Limitations Risk – The failure to de-accelerate a mortgage loan and revoke the foreclosure, when reinstating a loan, can result in the borrower having the defense that the statute of limitations has expired or requesting the discharge of the mortgage based on the expiry of the statute of limitations. In recent cases, courts have discharged a mortgage, holding that certain factors had not been met for the statute of limitations to be deemed to have stopped running; these include: evidence of the revocation of the acceleration by a clear, overt and unequivocal affirmative act; giving the borrower actual written notice of revocation before the statute of limitations expires; and the absence of borrower having changed its position in reliance on acceleration prior to revocation. In some cases courts have also not permitted lenders to discontinue a foreclosure if a borrower objects to the discontinuance for a variety of reasons.

Reinstatements/Pay-Off – In most states, upon acceleration of the maturity of the loan after default, a borrower may no longer simply cure the default, but must pay in full the accelerated amount of the loan. In certain states, however, a borrower may, for a set period of time after acceleration, still cure the default amount, in which event a lender is legally required to reinstate the loan to its original terms prior to the default. The receipt and application of cure payments proffered by a borrower after default and after acceleration is problematic. A lender's acceptance of a partial payment without adversely affecting its claims may be possible after default if the lender reserves its rights with respect to the default for the balance due. After acceleration, however, a lender's acceptance of anything less than the full accelerated amount may be deemed to be a waiver of the acceleration. Such action may adversely affect the continued prosecution of the foreclosure.

5. Preliminary Pre-Workout Agreements

Soon after default and after undertaking its initial internal review to assess the default, but before a lender commences any negotiations with the borrower or guarantors, a lender should take protective steps to limit or reduce its risk of liability to the borrower should the project and loan restructuring not work out. Some of these documents will effect the actual workout, while others are necessary to allow the contractual negotiations to occur without substantial risk to the lender. They act as risk management techniques and guides for a lender and caution the borrower against inappropriate reliance.

Pre-Negotiation/Settlement Letter – Before entering any negotiation with a borrower, whether for a restructuring, a deed in lieu, a consensual foreclosure or any other settlement proposal, a lender should secure the agreement or acknowledgment of the borrower and guarantor or their respective representatives that: any discussions are in hope of settlement and are not to be considered offers to lend, forbear, or waivers or anything other than a preliminary inquiry into possible common ground to workout the loan, and may not be relied upon by either party; all pending enforcement proceedings will continue unaffected; any proposals are not admissible as evidence and do not constitute waivers of a lender's remedies or modifications of the loan; and all agreements are subject to incorporation in a formal writing and lender internal approval procedures.

Forbearance/Standstill Agreement – If a lender decides to investigate a borrower's proposal, it can enter an agreement to forbear enforcement of any remedies or realization upon the collateral. A pre-workout agreement can be used by lender as a disclosure vehicle, a method of control of communication and conduct, and a means to assess the good faith of the borrower.

> *Limit Forbearance Perio* – The agreement will expressly limit the forbearance or enforcement proceeding standstill to a set period with a definite outside date. This limitation avoids any claim of inadvertent extensions and forces the borrower to provide its alternative on a pre-determined schedule.
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> *Lender Not Responsible for Downturn in Market* – The agreement will contain an acknowledgement of the borrower that any delays in the process are the risk of the borrower because a lender is not liable for the decline in value of the collateral, loss of leases or other variables of the marketplace during the workout period.
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> *Lender Diligence* – The forbearance period should provide a lender with adequate time to conduct due diligence of the several different aspects of the loan.
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> *Document Review* – Lender's counsel should review and analyze its entire loan and servicing files including internal memoranda notes of telephone calls, correspondence between the parties, evidence of conduct of the parties and others, and any other servicing materials in the loan administration files, as well as any formal written lender manual on workout foreclosure procedures. If the loan is serviced by a third party servicer, its loan administration files should also be reviewed for its actions as lender's agent.
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> *Property Review* – Whether a loan is to be modified or enforced, several different analyses should be updated. A foreclosure search of the title should be ordered and reviewed to establish if any additional mortgage liens, mechanic's or materialmen's liens or other interests exist against the property. A new appraisal should be obtained to establish current

valuation of the property. A lender can also request and obtain current rent rolls and, if possible, copies of any leases. An environmental site assessment (Phase I) should be arranged with the borrower to determine the property's current environmental status. If the loan is a construction site development or renovation loan, a lender may wish a construction inspector to review the work in place, payment requisitions and the contracts with any construction manager or general contractor and subcontractors. In other loans, considering the age of the building, an engineer building condition inspection and property condition report may be appropriate to assess capital expenditures that may be required going forward.

Borrower Review – Before deciding to proceed with a contractual workout, a lender must fully investigate its borrower and guarantors and their current financial condition. It should understand the current organization and management of its borrower, the identity of its principals and whether they are working together or fighting, whether there is any capital or credit available and whether the borrower or its principals have other problem properties or loans as well as any material uninsured litigation.

Interim Payments – To the extent available from the property and as a good faith gesture, a lender may require the borrower to pay the then current cash flow on account of the debt (even if this amount is less than the debt service) during the standstill period, after payment of taxes and expenses.

Non-Waiver of Default – The agreement should expressly acknowledge that the contemplated arrangement does not constitute a waiver of the borrower's default, act as an estoppel against a lender's rights and remedies or amend or modify the terms of the loan.

Borrower Alternative Proposals – If the borrower has proffered a restructuring of the terms to workout a defaulted loan, an outline of the proposal may be set forth in the Agreement to focus the borrower's efforts and prevent a scattered or "shotgun" approach. If the loan does not workout as the borrower promises, the borrower will be hard pressed to make other claims against a lender with this proposal in writing.

Borrower Default Acknowledgement – On any wish list it is desirable to have the borrower acknowledge the existing default for use as an estoppel in any future enforcement proceeding. A lender may also request a representation that there are no other defaults and no offsets or defenses. Although desirable, this will probably be unacceptable to the borrower and may unnecessarily hamper any discussion, but is not essential to the potential workout. However, in some cases the borrower may be willing to acknowledge the existence of the facts constituting the default without characterizing them as an event of default under the loan.

Borrower Covenants – In addition to confirming the existing covenants in the loan documents, a lender may request that the borrower expressly covenant to: make payments due under the loan documents as expressly modified by Agreement, keep the property insured against hazards, pay all taxes when due, maintain the property in good repair, pay all operating expenses of the property, not further encumber the property, observe all of the other covenants of the loan documents. The agreement should confirm that the loan documents are valid and enforceable and unmodified.

Independent Counsel/No Duress – Although clearly self-serving, a lender should require the borrower expressly acknowledge in the Agreement that it was represented by independent legal counsel and that the borrower was not subject to duress in entering the forbearance arrangement.

Agreement Default – The agreement should expressly provide that if the borrower defaults in its covenants in the agreement or its other unmodified obligations under the loan documents, the forbearance will terminate and the parties return to the *status quo ante.*

Guarantors – If the loan is guaranteed, the lender should obtain the same representations, covenants, and consents from any guarantors to prevent any future defense by a guarantor that the loan guaranteed has changed thereby vitiating its obligations under the guaranty.

6. Contractual Workout Alternatives

If a lender decides against instituting a judicial foreclosure proceeding, conducting a non judicial power of sale foreclosure or enforcing any of its other remedies against the borrower or any guarantors, a lender does have several available alternatives to work out the loan by restructuring the loan, the collateral, the borrower or accomplishing some other basic change in the transaction.

Loan Modification – Obviously, a borrower's alternative of choice would be to restructure the loan in a manner which alleviates its default and mitigates its loss under the loan without requiring the borrower to come out-of-pocket or to find other sources of financing. There are several ways to modify the loan to aid the borrower.

Increase Loan – A lender could agree to advance additional loan funds to the borrower. This advance may cover cost overruns in a construction loan, the cost of tenant improvement expenses for lease up of the property, the cost to cure latent defects discovered in a renovation, or for any other legitimate expense not properly foreseen at the origination of the loan.

Extend Term – The original term of the loan may be extended beyond its maturity for any number of reasons: to avoid looming refinance risk, to alleviate amortization of principal or to retain a loan which, because of unrelated market conditions, cannot be refinanced.

Interest Rate Reduction – To avoid having to take back a property in foreclosure, a lender may be willing to reduce an above-market interest rate to a market, or in certain instances below-market, rate for a part or the full term of the loan.

Deferral of Principal Payments and/ or Interest – Occasionally, a lender will agree to defer current monthly payments of principal or interest for a stated period or in consideration of certain borrower agreements.

Pay/Accrual Rates – A lender may agree to bifurcate the payments and provide for an accrual rate: accepting a lower current pay rate and permitting the deferral of the balance for recovery at some later date.

Contingent Interest – A lender may agree to recover foregone (or deferred and accrued) interest or principal in later payments that are contingent upon the happening of subsequent events, e.g., the sellout of a condominium project or sale above an agreed-on price.

Shared Appreciation – In a declining real estate market, a lender may protect itself by requiring payments on the sale or refinance of the property if the property appreciates in value at a later date.

Equity Participation – While not a "true" equity interest in the property, a lender may require payment to it as additional interest of a set percentage of the release prices upon the sale of individual condominium or cooperative units.

Convertible Debt – Although fraught with many legal problems, lenders may attempt to negotiate the right to convert all or part of its debt into an equity interest in the property. Although a few states statutorily permit this conversion from debt to equity, it is generally not permitted to be exercised upon a loan default because a lender would be deemed to be evading the foreclosure laws.

Forgiveness of Principal or Interest – In a declining market scenario, a lender may consider actual forgiveness of principal or accrued interest, especially if it has already written off those amounts on its books. This, however, may cause the borrower severe tax consequences for cancellation of indebtedness which it will likely wish to avoid or defer.

New Loan (New Lender) – Inasmuch as a lender may be constrained by its regulatory lending or internal loan limits, it may need to turn to others to provide funds.

Refinancing – A borrower may be given the opportunity to obtain a new loan - in the same amount or more - from a new lender to replace the loan held by the existing lender. In a severe credit crunch, this may be unlikely to succeed in an illegal market.

Additional Loan – Another lender may agree to lend additional funds to the borrower upon taking other collateral of the borrower or separate credit support, or upon a lender's subordination of the existing loan's lien priority to the new lender's loan.

Participant – A lender may be willing to sell a portion of the existing loan to a participant who either may buy a defaulted portion of the loan or fund additional advances by the lead lender. This will enable the loan to be funded despite a lead lender's funding issues.

Mezzanine Debt/Preferred Equity – For the infusion of additional capital to the transaction, a lender may permit a borrower to arrange a mezzanine loan and consent to the pledge of the borrower's membership certificates as security or may consent to the borrower's grant of preferred equity to an investor in the borrower.

Collateral Modification – Aside from the loan, the collateral for the loan may be restructured to address a lender's concerns:

> *Direct Active Assignment of Rents* – Considering a lender's concern for preserving the mortgaged property's cash flow, a borrower may agree to direct tenants to pay rents directly to the lender for application to the debt with any balance being held in a lender's reserve account or reverting to the borrower. This active assignment with a present consent can be accomplished by modifying the existing "default" assignment of rents or executing a new document. This method allows a lender to monitor the property's cash flow and prevents "milking" by the borrower.
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> *Take Additional Security* – Faced with a declining market, a lender may be seeking additional collateral to improve the loan to value ratio to an acceptable level. This course of action has obvious bankruptcy limitations of preference or fraudulent transfer claims by debtor, its bankruptcy trustee or its other creditors should the borrower enter bankruptcy.
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> *Change Use of Project* – A borrower may approach a lender to allow a change in the proposed or existing use of the property to better assure repayment of the loan. In an overbuilt transient hotel market, a college dormitory or apartment may be a more viable project and more attractive collateral in the marketplace as would a repurposing of a retail shopping center.

Borrower Changes – The problem with a project may not be the property, but the borrower or its principals. Their competence, credit or internal disputes may be the reason for the disruption of the project's success.

> *New Managing Member* – In many cases, a managing member may be experiencing difficulties in other projects. For example, sponsors who are no longer being paid management or other fees may lose interest in managing a property. Also, the ability to develop a project may not always easily translate into an ability to workout a troubled property. Finding a capable real estate workout specialist may save the property and the loan.
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> *New Equity (New Members)* – It may be, however, that borrower's problems are not the result of management by, or organization of, the managing member, but the lack of available resources to invest as working capital in the development of the project. A construction loan may be out of balance or in excess of a lender's loan to value limits. Additional borrower equity may be accomplished by an infusion of cash into the project through a borrower raising equity by admitting a new managing member or new economic members willing to make capital investments or loans to the entity or permitting the issuance of preferred equity.
>
> *Joint Venture with Lender* – In times of tight credit markets or inflation, lenders have often looked to joint ventures as a hedge. This investment vehicle may also prove useful in the workout of a loan as a method of infusing additional funds. This method is problematic in

the investment arena, but the potential lender liability issues which arise entering such an arrangement in a loan workout are exponentially greater. From “esoteric” claims of clogging the borrower's equity of redemption to assertions of control to the risk of recharacterization of a lender's remaining loan as equity, the lurking issues are serious risks for a lender.

Addition of Third Party – A less risky way to accomplish an advantageous joint venture is to permit a cash strapped borrower to joint venture with a money venturer, or a management challenged borrower to join with an accomplished development venturer. This will allow for greater flexibility for the borrower in the resolution of its troubles. There are, however, other third parties who, of necessity, may be involved in the problem and its solution:

New General Contractor or Construction Manager – In the case of construction financing, the cause of the default may be the general contractor or construction manager chosen by the borrower. Inexperience, poor project management, trouble with the subcontractors, conflicts with other parties or a borrower acting as its own general contractor may interrupt or impair the successful progress of the job. Often, a new contractor or construction manager may quickly alleviate the construction oversions, delays, construction defects, or other disruptions. A lender, however, should be careful not to impose its choice of contractor or construction manager, but only recommend to the borrower several acceptable contractors or construction managers from which borrower may chose to retain.

Mechanics' Lien Resolution – The quickest way to stop a construction job in progress is the filing of a mechanic's or materialmen's lien against the property. Title continuations prior to loan advances should warn a lender of liens and in many jurisdictions would create an impediment to further funding of the loan. Even in obligatory advance jurisdictions with absolute lien priority, a lender may be concerned about the cause of the nonpayment of the lienor. The only viable solution to this problem is for the borrower to bond the lien off record, settle and pay the lien or otherwise have it discharged of record.

Title Policy Claim – An oft neglected solution to certain problems is the liability of the title underwriter pursuant to a lender's loan policy of title insurance. Title failures, missed liens and other title issues may be resolved by the title insurance company either by settlement, correction of the record, defense or payment, as appropriate. While filing a claim may be premature, communicating this issue in writing to the title insurer is of paramount importance to preserve a lender's rights in the future. If possible, additional title insurance coverage, including endorsements and affirmative insurance, should be obtained for as much of the new transaction as is possible under state title insurance regulations.

Disposition – Of course, a lender could eliminate its concerns with the troubled loan if it were able to sell the entire whole loan and its attendant risks. Sale of part of the loan as a participation interest or otherwise is likely to increase a lender's risk unless a lender also transfers the risk of servicing and retains a small pari passu or subordinate interest in the loan. Bringing in a new lead lender more qualified in the type of loan, type of property or the local market may increase the possibility of a successful workout.

Sale to Third Party – It is the hope of all borrowers that in a short time they will be able to sell their interest in the troubled property and thereby protect their reputation as well as their equity investment. Unfortunately, the borrower's view of the value is often inflated when objectively tested by the market place. Also, the borrower usually believes that if it could only hold the property for some additional period of time the market might return, making an equity recovery possible. A lender must tread carefully in suggesting a sale or dealing with third party purchasers itself. The risk of lender liability increases with lender participation in disposition.

Abandonment – With the risk of possible catastrophic environmental liability, more lenders have considered the alternative of abandoning their interest in the collateral rather than risk further involvement in the property. Yet there are other circumstances where lenders walk from an investment. The current value of the property may not be sufficient to cover necessary protective advances. In the case of a second or other junior mortgage lien, there may simply be insufficient equity coverage to warrant the expenditure of time or money. For example, protective advances to cure ground lease defaults may not be prudent with a declining value ground lease. The inability to recover the additional costs as well as the initial investment may lead a lender to conclude that its debt is worthless.

Real Property Transfer Taxes – Another critical risk in workouts involves the differing impact of possible real property transfer taxes (or additional mortgage taxes) payable in the restructure which might not be payable in the event of a foreclosure or bankruptcy. Tax counsel should be consulted to assess the state and local as well as federal tax consequences of each alternative a lender may wish to consider.

Legal Compliance – Before undertaking any modification involving a new or reconstituted borrower or guarantor, new principals, a new lender, a new equity investor or any other new party to the loan or any change in control of the borrower, a lender should comply with any and all federal and state laws, regulations, rules and orders with respect to Know Your Customer, Anti-Money Laundering, Beneficial Ownership, CFIUS, and other similar required compliance obligations and its own internal procedures.

7. Documenting the Workout

If a contractual restructuring is determined to be most advantageous by a lender, it will require the execution and delivery (and recording) of numerous documents with the several different parties to the loan transaction.

Workout Agreement – If the negotiations for the workout of a loan restructuring are completely satisfactory, it is important to memorialize the parties' agreements in a single comprehensive "workout" document which contains the necessary representations and warranties, covenants, consents and conditions precedent and subsequent. Such a document will serve to confirm the intentions of the parties to the workout and act as a guide though the necessary steps at the successive stages of the workout. The document should also contain the triggers for default under the workout agreement and the procedures for unwinding or modifying the workout in the event of subsequent changes. Yet this is only the basic document; there are many other documents that must be drafted, negotiated, executed and delivered in conjunction with any successful workout.

Modification of Existing Loan Documents - Most importantly, the loan documents themselves must be modified and the changes placed of record to reflect the restructure agreement of the parties. Among other things, the notes or loan agreements should be modified to extend the term of repayment, adjust amortization or capitalize past due amounts, change the pay or accrual rate of interest or alter the payments. Depending on local custom, these changes could be done by separate agreement or incorporated in the necessary modifications to the mortgage instrument. The lien of the mortgage could be spread to encumber additional real property or additional mortgages granted to encumber other properties or secure an increased amount of debt. Additional security interests in personal property may require amendments to the existing security agreement (if not contained in the mortgage) or a new security agreement (if new collateral) and a related UCC financing statement filed to perfect the security interest. Any change in the collateral, lease or rent assignment should be made of record to notify third parties. In addition to recording the modification, if the rents are to be paid directly to the lender or its agent, this active assignment should be made known in writing to the tenants. Any other documents evidencing, securing, guaranteeing or insuring the loan should be reviewed to determine the impact of the restructure and, if affected, revised accordingly. No matter what the specific purpose of a loan modification is - an extension, amendment of defined terms, addition or deletion of provisions - it is imperative that the lender take the opportunity, as a condition to the modification, for its counsel to take into account legal and market changes that have occurred since the origination of the loan, or its last modification, and to include any provisions that are now required to be in loan documents at the time of their origination.[2]

Modification of Collateral Documents – While the importance of the loan documents is obvious, the consequence of the modification on certain collateral documents is also of great importance to the success of the workout. The borrower's organizational documents may need to be amended to accomplish the agreed-upon changes. Entity formation agreements may need to be amended to substitute managing members, admit new members, give priority to, or subordinate, loans to the entity, change management or control or impose new restrictions. New filings may be necessary regarding such changes in the entity vehicle. Any change in the ownership, use or status of the property may require documentation to be created, notices given, instruments recorded, applications filed or governmental consents obtained. Due consideration of the impact of the restructuring on the underlying organization of the borrower, status of ownership vehicle, title, governmental certificates, licenses or permits, third party agreements, title documents, leases and other collateral matters will be a prerequisite to the consummation of the contemplated transaction.

Modification of Organizational Documents - To complete the documenting of the modification process, it will also be necessary to modify the organizational documents of the borrower and the guarantor to: conform their respective terms, conditions and limitations with the terms, conditions

[2] For example, if the legacy interest rate benchmark for a floating or adjustable rate loan is LIBOR, care should be taken to update the interest rate provision to include the transition from LIBOR to the new replacement benchmark as well as provide the triggers to the transition; a fallback waterfall of benchmark rates and a fallback waterfall for LIBOR counterparty spread such as those proposed by the Federal Reserve Bank of New York's Alternative Reference Rates Committee or whatever other transition language the lender has decided on for its legacy portfolio and new originations.

and limitations agreed to in the contemplated workout of the loan as evidenced by the requirements of the loan modification documents; expressly reflect any of the changes in the entity's membership, management, ownership, and organizational structure without changing or impairing, but expressly confirming, the special purpose entity and separateness status of the borrower, guarantor and any of entity's in the vertical ownership stack of the borrower and guarantor; and incorporate any terms, conditions or limitations which the lender, at the time of the modification, would require in the organizational agreements of the borrower and guarantor in the origination of a new mortgage loan.[3] Depending on the type of entity, there may be additional related documents that may also need to modified to conform to the amended organizational documents and filed with the appropriate governmental authority. In addition, the borrower and guarantor will need to deliver the satisfactory evidence that required entity authorization and necessary third party approvals and consent to the contemplated workout have been obtained and it is has the authority to enter into the workout arrangement.

Title Clearance Documents – As the lien of the loan is probably insured by a loan title insurance policy, all documents should be submitted to the insurer for clearance prior to execution. If any entity change has occurred, the borrower should obtain an endorsement to continue coverage. Additional title documents may be necessary to deal with matters found to be of record subsequent to the original loan. To prevent any denial of coverage later, it is important to keep the title insurer fully aware of the structure and documentation of the restructure.

Guarantor Consents – In any situation in which a guaranteed obligation changes in any way whatsoever, a lender must assure itself of a guarantor's consent to the contemplated transaction and its documentation to avoid the potential release of a surety under suretyship principles. Although these suretyship rights are often routinely waived by a guarantor in guaranty documents, a guarantor's written consent in the file is much greater comfort than making arguments in a legal proceeding.

Title Policy Endorsements – The title policy standard exclusion for acts of the insured is problematic for every loan workout as it could eliminate coverage for the action taken by lender. The Creditors' Rights Exclusion contained in the ALTA loan title can also be a problem in a workout especially in the case of a fraudulent transfers or preference or equitable subordinations. An updated title search should be obtained to raise any risks to be considered and appropriate endorsements to be obtained, if available, to protect against any title risks associated with modifying the loan. Confirmation of ownership, subordinate lienors and lien priority is essential to successful completion of the contemplated workout.

Other Loan Party Consents – If lender has contractual obligations to Other Loan Parties or becomes aware of Other Loan Parties, it should assure itself by confirmation in writing either that its actions are sanctioned by the Other Loan Parties or that the modifications or enforcement actions do not require their express consent. In any event a lender should obtain the written

[3] For example, if the borrower or guarantor or their vertical ownership stack are Delaware LLCs, the loan documents should be updated to prohibit a Division or a Divisive Merger and the LLC agreements of all the parties to the loan should be modified to absolutely deny the right, power or authority, express or implied, to divide or engage in a divisive merger and that provision should not be able to be amended and any attempt to do so should be null and void and ultra vires.

consent of Other Loan Parties to any modification or enforcement to avoid lien priority, subordination or other claims.

Capital Markets Arrangements – Similar to guaranties, any financial surety, letter of credit or other credit support vehicle should be reviewed for the conditions to its enforcement and appropriate action taken to preserve the credit enhancement from diminishment or loss due to the consequences of the workout. Again, the credit enhancer's written consent to the restructuring is the best protection for a lender to preserve the credit support vehicle.

Borrower Confirmations – Before entering into a workout with a borrower, guarantor and their principals, the borrower, guarantor and principals must confirm several facts in writing to lender:

> First, that the borrower and any of its related parties required at origination to be special purpose entities (SPEs) continue to be SPEs and continue to abide by their separateness covenants; and
>
> Second, if the borrower or guarantor are Delaware limited liability companies that their LLC agreements absolutely prohibit their power and authority to divide under Delaware law, that the prohibition of division may not be amended and any amendment shall be void and of no force and effect. (Lender should also modify its loan documents to prohibit division or any amendment to the LLC agreement to allow it. Any attempt or any division by the borrower or guarantor should constitute grounds for full recourse for the debt under a Non-Recourse Carve-out Guaranty.)

8. Foreclosure

The procedures for conducting the foreclosure of a mortgage is a creature of state statute and local court rules as well as the contractual terms of mortgage being foreclosed. There are probably more different judicial and nonjudicial procedures and rules than there are states in the Union. And the process and timing can vary significantly from state to state and within a state. Some states also require that the mortgage contain certain provisions such as: the right to choose the non-judicial over the judicial process; who can act as trustee in power of sale; the ability to obtain a deficiency; and limitations on the calculation of the deficiency. The foreclosure process can generally be divided into four different procedures, although some states may allow more than one method of foreclosure:

Strict Foreclosure – This is the most traditional foreclosure procedure, a creature of English Common Law and not statutory. A lender sets a law day for redemption and if the parties do not redeem within their allotted time period, they forfeit their equity in or claims against, the property. Hence, without a public sale, the foreclosing lender simply retains title to the mortgaged property after foreclosing the borrower's exercise of its equity of redemption and barring claims of any subordinate lienors and tenants.

Judicial Foreclosure Sale – In many states foreclosure requires the commencement of a court proceeding against all parties having an interest in the property. Afterwards, the junior interests have the opportunity to respond and delay the proceeding to their advantage. It is a time consuming and expensive method for a lender to realize on the collateral.

Nonjudicial Power of Sale – Trustee Sale/Sale by Advertisement – An expeditious and efficient enforcement procedure is the nonjudicial public sale by a statutory officer or trustee after several weeks of advertising in the prescribed statutory method. A borrower can still enjoin or prevent the sale (but at significant cost) by commencing an action for injunctive relief or by filing for bankruptcy.

Sale by Receiver – While a property may be sold by a court appointed receiver in seven states under the Uniform Commercial Real Estate Receivership Act (2015) that process is beyond the scope of this discussion.

Supplementary Proceedings – The following proceedings may be required simultaneously or subsequent to the foreclosure proceeding to execute the results of the foreclosure and sale of the collateral:

> *Surplus Money* – A surplus money proceeding is conducted to distribute the proceeds of a foreclosure sale in excess of the amount necessary to satisfy the foreclosing lender's debt (and recover any protective advances and expenses permitted in the jurisdiction).
>
> *Deficiency* – Conversely, a deficiency proceeding is a procedure to set the amount still owing to the foreclosing lender by a recourse borrower or guarantor after the realization of proceeds upon the sale of the collateral. This supplementary proceeding is used primarily against borrowers in recourse loans or against guarantors of payment. While a lender may be prohibited from obtaining a deficiency judgment in some states, in other states, which permit a deficiency judgment, the amount of any claimed deficiency may be limited to the difference between the debt and the fair market value of the collateral, rather than the debt and the actual proceeds realized at the foreclosure sale.
>
> *Writs of Assistance Eviction* – Whatever this procedure is called, this proceeding enables a foreclosing lender to oust junior interests - which have been foreclosed - from possession or occupation of the foreclosed property.

Election of Remedies/One Action Rule – A borrower or guarantor can always resort to available statutory procedural defenses. In a state where (unlike English common law) a remedy is elected at the inception of an action, a suit on the debt - note or guaranty - may preclude an action to foreclose the mortgage unless certain specific conditions are met or court consent to proceed is obtained. Security-first states may require a lender to proceed first against the collateral and then, to the extent permitted, against the borrower for the deficiency. Finally, in a small number of western states, a lender has only one action available to the express exclusion of any other action. Thus, a suit on a note may preclude ever foreclosing the mortgage. Sanctions may also be available to the borrower to void the security interest in certain cases. In such states, and in multi-state transactions, local counsel should be consulted before any action is taken, as the result could limit or terminate the lender’s ability to enforce its rights and remedies. Realizing on an escrow account, guaranty, letter of credit or personal property prior to foreclosure could result in releasing the remainder of the collateral from a lender's security interest.

9. Suit On Note/Guaranty

In the case of loans where the borrower is personally liable for the debt or the debt is guaranteed or indemnified by a third party, a lender may proceed directly to sue to collect the debt instead of relying upon the liquidation of the collateral. In many states, there are legal limits to a lender's ability to proceed on the note, as well as the timing and sequence of such an action, and in certain states there are significant legal consequences to proceeding on the note first, as mentioned above. An initial determination of jurisdictional limits should be made to avoid any unduly harsh sanctions associated with suing on the note. In loan transactions with multi-state collateral, these limits may have extra territorial consequences, especially if the note secured by the mortgaged property is governed by the law of a state different from the mortgage.[4]

Recourse Liability – Unless the loan documents expressly limit the borrower's liability to the loss of the collateral, a lender may seek a money judgment to recover the debt. Unfortunately, this judgment will not be enforceable against the mortgaged property, although it can be used to realize on other assets of a borrower. Moreover, in most cases during the pendency of an action on the note, a borrower will be free to deal with the mortgaged property unless a lender's rights and remedies are being exercised in a foreclosure.

Non-Recourse Loan – It is common in many commercial real estate financings for a lender to agree to look solely to the property securing the loan and to agree not to seek a money judgment against a borrower. This non-recourse arrangement merely limits the personal liability of a borrower, but does not affect existence of the debt. If properly drafted, this arrangement should not affect a lender's ability to sue for a borrower's breach of non-monetary covenants or other obligations by way of injunction, prohibition, etc.

Non-Recourse Liability Carveouts – Most lenders require that for any non-recourse loan, a creditworthy affiliate of the SPE borrower or its principals nevertheless deliver a Non-Recourse Carve-Out Guaranty. The standard "above the line" carve outs cover actual losses or damages suffered by lender as result of a "bad boy" acts such as fraud or misrepresentation; intentional physical waste; misappropriation of rents, insurance proceeds and other funds; failure to comply with certain covenants regarding insurance or environmental matters; and a host of other acts causing loss. "Below the Line" carveouts trigger full recourse for the debt for violation of the due on sale /due on encumbrance clause; change of control; voluntary bankruptcy filing or a collusive involuntary bankruptcy filing; terminating independent directors or failure to remain an SPE resulting in substantive consolidation; or dividing the SPE borrower or guarantor Delaware LLC. While the panoply of carveouts for losses and full recourse vary from lender to lender and

[4] For example, some lenders outside of New York require that their mortgage notes be governed by New York law. While New York courts have held that its deficiency judgments statute does not apply to mortgaged property located outside of New York, some courts in jurisdictions other than New York have held that a mortgagee's choice of New York law provision contained in the mortgage note would require the application of the New York "market value" deficiency rules to such out-of-state foreclosure because deficiency judgments are a matter of the debt which is evidenced by the mortgage note. Another problem that must be carefully considered before commencing foreclosure(s) involves understanding the risks inherent in multi-state, multi-property loans when the lender intends to obtain the full benefit of the cross default and cross collateralization of the mortgaged properties. To avoid the draconian consequences of the application of the various state deficiency judgement limitations and the penalties of one action rules, the lender must, with the assistance of counsel, carefully consider and monitor its sequence and timing of the foreclosure(s) and the subsequent enforcement of any deficiency judgements to receive the full benefit of loan structure.

sometimes between borrowers for the same lender, a lender should review the carveouts in its documents to ascertain if there is any potential liability under the guaranty that can be pursued or used as leverage with a borrower or a guarantor in the workout negotiations.

10. Obtaining Rents

If the collateral is income producing property, a lender will be concerned with the proper application of the rents, issues and profits from the leased property to debt service, taxes and related operating expenses. A borrower may have other uses for the monies; for example, a borrower may want to pay a recourse second mortgage or other liens on the property. Lenders ordinarily seek to avoid this "milking" of their collateral by borrowers in several ways:

Mortgagee in Possession – The "gut" instinct of most lenders is to simply demand that a borrower and its tenants direct all further rent payments after default to the lender. If a borrower consents to the current payment by tenants to the lender, there is nothing further that needs to be done. It is highly unlikely, however, for a borrower to consent to this after default. Without a present consent, a lender runs the risk that its demand for rent will be deemed to evidence its exercise of dominion and control over the property thereby being liable as a mortgagee in possession. As such, a lender may be liable to a borrower (and possibly third parties) for any losses that occur during its operation and control of the mortgaged property as well as any perceived consequences to its value.

Activate Assignment of Rents – While most commercial mortgage loan documents, either in the mortgage or a separate assignment of rents, require a borrower to assign the rents to a lender, it ordinarily is a so called "default" assignment, effective only on borrower's default. Other assignments purport to be present active assignments, with a license back to the borrower until its default. In either case, the consent of a borrower is given in the loan documents at loan origination. As most states require an absolute present active assignment of rents, lenders will not have a perfected security interest in the rents. Even if a lender is able to activate the assignment with a present consent, in many cases a bankruptcy judge in a borrower’s bankruptcy may still stay any further collection of the rents by a lender, even in the case of an absolute active assignment of rents with the borrower’s present consent.

Appointment of Receiver – Notwithstanding a lender obtaining an assignment of rents, in most cases a lender does not proceed to collect the rents itself, but prevents a borrower from collecting the rents by having a court appointed receiver collect them and pay for the cost of running the project. Except in the foreclosure of a junior mortgage where senior mortgage debt service would be an expense of the property, the receiver does not pay the mortgagee's debt service, but retains any monthly surplus for possible application upon foreclosure or to required property expenses and taxes.

> *In Foreclosure* – While the ability of a lender to obtain the appointment of a receiver depends exclusively on local law and practice, it is generally easier to obtain a receiver as part of the foreclosure process. In some states, a lender may obtain a receiver without notice or hearing, enabling a lender to move swiftly. Of course, some states do have rules limiting a lender's right to a receiver. Notwithstanding state law, in a foreclosure conducted in the federal courts notice and hearing would ordinarily be required.

In Equity (outside foreclosure) – Obtaining a receiver of rents outside of a foreclosure action is clearly more difficult. Although the express contractual provisions of the assignment may alleviate many obstacles, there will be statutory hurdles to be met by a lender, especially if notice to all parties and a court hearings on the sufficiency of cause are required as a condition to appointment of the receiver.

11. Environmental Issues

Before consummating a workout or commencing a foreclosure or accepting a deed in lieu of foreclosure, a lender should conduct an assessment of the current environmental condition of the mortgaged property, including a review of the environmental site assessment and any updates.

Risks to Lender **-** If based on that review the lender is confronted with existing or potentially new environmental problems at the mortgaged property, lender, in conjunction with its environmental experts, will have to consider and decide how to best avoid the potential: costs and expenses of a clean-up; liability to adjacent landowners, third parties, and the tenants at the mortgaged property; liability to governmental authorities, and the indeterminate or possibly catastrophic losses arising from the environmental condition; and yet retain its secured creditor exemption, while attempting to preserve the value of its real estate collateral.

Lender Options - The lender has several viable options depending on the environmental condition of the mortgaged property and the panoply contractual rights and obligations under the loan documents and the environmental indemnity, as well as the applicable insurance policies which would allow lender to:

- exercise its rights against the indemnitor under the Environmental Indemnity, that was delivered at the origination of the loan, for remediation of the condition and/or reimbursement for costs
- inquire into the coverage provided by any policies of environmental impairment insurance and/or the contractors environmental liability insurance that were obtained at origination and proceed in accordance with the terms of the policies
- commence litigation against the indemnitor for its/lender’s rights under the Environmental Indemnity
- commence the foreclosure of the mortgage including a claim for losses under the nonrecourse carve-out guaranty on account of the environmental condition
- have a receiver appointed in the foreclosure to undertake further invasive investigation of the mortgaged property’s condition and the required clean-up
- and as a last resort, abandon the contaminated property that is the mortgaged collateral for its loan

which in all cases to avoid the perceived risks of ownership or operation of the mortgaged property.

There is no one size fits all analysis or course of conduct in these cases. Like real property generally, the particulars of the contamination or other environmental condition of any mortgaged property will also be unique and must be dealt with in a manner that will preserve its secured creditor defense.

12. Deed In Lieu Of Foreclosure

Accepting a deed in lieu of foreclosure is a faster and more efficient means for a lender to realize on the property that constitutes the security for its loan. While a deed in lieu avoids the cost and delays attendant to foreclosure, it only allows a lender to step into a borrower's shoes *i.e.*, subject to all existing liens and interests, as well as claims, without the benefit of the priority of its security interest over all subordinate claims. The major issue in these transactions is the need to avoid fraudulent transfer or preference claims in a later bankruptcy. There are advantages and disadvantages to the deed in lieu. There are ways, however, to preserve certain rights and remedies of lenders in such cases.

Use of a subsidiary – By taking the deed in lieu in the name of a subsidiary of a lender subject to a lender's mortgage, the lender can legally and publicly distance itself from the property. A lender can also retain its mortgage lien to use as leverage with other lien-holders to workout the troubled property. This method also preserves the lien in the event the deed in lieu is set aside as a fraudulent transfer or preference in a subsequent bankruptcy or other proceeding.

Subsequent foreclosure – By retaining its lien position and using a subsidiary or having anti-merger language in the deed in lieu, a lender can subsequently foreclose against its subsidiary to rid itself of liens and other interests not affected by the original deed in lieu.

Covenant Not to Sue – Borrower may request, but must never be granted, a general release in consideration of its deed in lieu, as it may constitute a satisfaction of the debt and a resulting discharge of the mortgage. A lender can, however, give a borrower and any guarantor a covenant not to sue for a deficiency judgement which would also serve as sufficient consideration for the deed (although it may not constitute value for purposes of the state’s recording acts). Nonetheless, the covenant not to sue should contain an express condition subsequent that it does not preclude any claim by lender for breach of deed warranties and any environmental contamination liability.

13. Other Lender Alternatives

Bankruptcy – While lenders generally seek to avoid the bankruptcy process, a lender may use, or encourage the use by other creditors of, the involuntary bankruptcy process to preempt a borrower filing at a later and possibly less opportune time in the enforcement process. There may also be advantages to selling the property out of the bankruptcy, *e.g.*, possible transfer tax avoidance.

Single Asset Real Estate Bankruptcy – Since the removal of its original $ 4,000,000 cap in 2005, lenders have an increased interest in the advantage of the expedited procedures of the single asset real estate bankruptcy process. Provided that the mortgaged property is a single income producing property or project (and not a 1-4 family residential unit) with no other substantial borrower business, the automatic bankruptcy stay will be terminated if the borrower fails to file a plan of reorganization or commence monthly interest payments within 90 days of its filing for bankruptcy which gives the lender added leverage and may be a significant hurdle for the borrower.

Prepackaged Bankruptcy – Lenders are generally amenable to borrower prepackaged bankruptcy filings because the filing is accomplished with a plan of reorganization with creditor acceptances (or at least solicitations initiated) before filing. While there are certain legal and practical limitations on its availability in the particular circumstances of the borrower and the creditors, it is clearly a more cost efficient as well as a shorter and simpler process than a typical Chapter 11.

The foregoing cases should not trigger full recourse for the debt under the borrower or guarantor's nonrecourse carveout guaranty for bankruptcy.

Protective Advances – A lender may advance additional monies which will be secured by the mortgage lien as protective advances for the payment of taxes, insurance, repairs, tenant improvement costs, etc. under the loan documents to protect the priority of the lien of its mortgage.

14. Borrower/Guarantor Defenses And Claims

Notwithstanding precautions and prophylactic measures taken in originating, servicing, restructuring or enforcing the loan, the borrower or guarantors will invariably assert certain defenses to any lender enforcement proceeding and as a matter of course make extravagant claims of lender liability in an attempt to thwart or delay realization on the collateral by a lender. While the potential defenses/claims may be as numerous as the factual circumstances of each loan, a few defenses and claims seem to recur with some regularity in most cases when a lender seeks his remedies:

- Mortgagee in Possession;
- Recharacterization As Equity;
- Breach Of Good Faith/Fair Dealing;
- Tortious Interference;
- Oral Waiver/Modification;
- Marshalling of Assets; and
- Rel*ease of Guarantor.*

15. Risk of Recharacterization

With the continuing evolution of lender liability litigation, borrowers and guarantors in any non "cookie cutter" loan with any equity-like lender protections or controls, will often raise the defense that the lender is really an equity investor. If the lender is found to be the borrower's partner, foreclosure is an impermissible remedy and the lender is constrained to the partner's remedies of accounting and partition. If the mortgage is held to be an equity interest, it may have been recorded in the wrong records (i.e., not the conveyance records) and the mortgagee may have partner liability. Moreover, during workout or default negotiations, the lender's statements with respect to assisting a borrower, mutuality of interest, and "entity-like" references may lead to the claim that, notwithstanding the express terms of the documents, the lender viewed the transaction as an equity investment or an entity interest, with the obvious result if a court agrees.

Beyond the enforcement and perfection risks of the recharacterization of the loan as an equity interest (a "partner") there are some risks well beyond the mere loss of collateral for which a lender may be adjudged liable.

To Third Parties – As a partner of a borrower, a lender recharacterized as a partner will be responsible for its share of all of the debts and other expenses and liabilities incurred by a borrower in its capacity as owner/developer of the property encumbered by the mortgage. A lender could potentially owe substantial sums as well as possibly be subject to environmental liability as owner/operator. A lender may also be liable for transfer taxes in certain states. Title insurance coverage may also be affected unless care was taken at loan origination or workout to cover the recharacterization issue.

To Borrower for Project Failure – Aside from its third party risks, a lender may face claims from its borrower/"partner" that it failed to come up with necessary funds to keep the project going and that certain actions and decisions of a lender/partner were violative of its partner obligations to the partner/borrower. Of course, a borrower does run the risk that it has not filed its tax returns consistent with its current claim of its recharacterizated relationship with a lender. For tax purposes, a borrower will have overstated its deductions in the recharacterized transaction and its interest deductions for the recharacterized loan would be improper. Very few claims of recharacterization do not pose concomitant risks to a borrower.

As Mortgagee in Possession – Similarly, if the lender has been determined to have become a mortgagee in possession by taking rents directly from tenants or otherwise exercising dominion and control over the mortgaged property or its operation without the present consent of the borrower, it will have committed trespass and may be adjudged potentially liable for mismanagement of a productive property including maintenance of the property, waste, making necessary repairs, negligence for third party injuries, maintaining the property insurance, paying taxes and insurance premium, and otherwise performing duties imposed on owners by law while also assuming environmental liability as an operator who is no longer protected by its status as a secured lender.

16. Bankruptcy Risks

Fraudulent Transfers – While a properly conducted non-collusive judicial or nonjudicial statutory foreclosure is no longer susceptible to being held a fraudulent transfer for failure to produce reasonably equivalent value (as it was for a short time after the savings and loan crisis), and be set aside, deed in lieu transactions will, however, be subject to claims as fraudulent transfers and capable of being set aside. A trustee can assert that a lender should have known it was a fraudulent transfer and therefore did not act in good faith, and thus ask the bankruptcy court not to restore the foreclosed mortgage lien to a lender, leaving a lender without any interest in its former collateral. This risk will also be present if a lender attempts to take additional collateral or substitute very differently valued collateral in a workout.

Preferences – The very nature of workouts, restructurings and deeds in lieu of foreclosure involve antecedent debt. The lack of new value will allow claims of voidable preferences to be raised. The granting of additional security without new value, unscheduled prepayments of principal, etc., will subject a lender to preferential transfer claims in a borrower's bankruptcy.

Equitable Subordination – Also arising in bankruptcy is the risk that a court will subordinate a lender's lien to junior liens because of some perceived inequitable conduct which damaged a borrower or junior lienors. A guarantor might argue that the conduct of a lender in restructuring of the existing guaranteed loan released a guarantor from the terms of its original obligation. Although most guarantees waive these rights, guarantor consents to all workout actions are always preferable to enforcement litigation.

17. Loss of Title Insurance Coverage

When a specific action taken, or inaction by the lender in the workout, raises bankruptcy risks and recharacterization risks discussed above, the title insurer may deny coverage as an excluded act of the insured under the loan title insurance policy. In the case of a recharacterization where the mortgagee is deemed an equity partner of borrower and not its lender, coverage may be denied as an equity interest has been insured under a loan policy and if there is split (conveyance vs mortgage) recording system the instrument may be deemed to be recorded in the wrong land records and not serve as constructive notice of the lender's purported debt.

18. Risks Of Lender Liability

Whether a lender chooses to enforce its remedies or contractually restructure the loan transaction, it should avoid acting or failing to act or communicate in a manner that would subject the lender to a claim for lender liability by a borrower, guarantor, or Other Loan Parties.

Borrower/Guarantor

In dealing with the borrower and the guarantor as well as their respective principals and counsel, there are some simple guidelines that should absolutely be observed by a lender and its agents as to what action, inaction or communication that should be avoided by lender in all circumstances after default:

- Taking Precipitous Action;
- Threating Action Not Contemplated;
- Interfering With Control or Operation of the Property;

- Making Inconsistent Statements;
- Calling an Improper Default;
- Overreacting; and
- Creating False Hopes by: Inaction/Delayed Response.

Other Loan Parties – Another risk in a workout arises not with respect to the debtor-creditor relationship, but arises out of the unique issues involving the contractual rights, duties and obligations of lenders owning a loan. Lead lenders may have to sue Other Loan Parties for protective advances. Other Loan Parties may sue lead lenders for alleged improper servicing of the loan. In such cases, the lead lender will now be faced with a two-front financial battle. Proper decisions may be frustrated or sabotaged by concerns of liability to Other Loan Parties. Workouts are hard enough without attempting a restructuring in the context of committee actions, or worse, tranche warfare.

Conclusion

To maximize the recovery of its investment by realization on its collateral (or otherwise) in the most cost effective and time efficient manner in a declining real estate market, a lender should adopt and implement a consistent workout strategy of sufficient breadth to encompass all potential variables and circumstances: senior vs. junior lien; construction vs. permanent loan; fee vs. leasehold loan; owner/user vs. single tenant vs. multiple tenant properties; sole lender vs. multiple lender arrangement; supervised vs. unregulated lender; tax shelter vs. economic borrower; cooperatives vs. condominiums vs. residential rentals; a primary market vs. capital markets origination. Only by knowing alternatives available to it, choosing the alternative that best addresses the particular variables and circumstances and recognizing its own motives, can a lender achieve an optimal result.

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