March 2009

Real Estate Project in Distress

A Case Study in Restructuring; Alternative Approaches and Strategies

THE SCENARIO

Twenty-four months ago, everyone had signed off. Due diligence was diligently done, comparables were compared, estimates were estimated. The project appeared sound. The construction would be complete in two years and, in the meantime, like clockwork, buyers, investors—anyone with cash—would enter into contracts to buy condominium units in the completed building. When the loans closed, everyone went out for a celebratory drink, all sure that success was a foregone conclusion.

Today, the stock market is down over 40 percent from its high, credit is unavailable and capital is parked on the sidelines, no one willing to try and catch a falling knife while the market searches for "the bottom." Consumer confidence is down and unemployment is up. By all accounts, the economy is in a deep recession. The effects are being felt both globally and locally.

Our mezzanine loan is in trouble: the project is behind schedule and over budget, the condos remain largely unsold and those purchasers who did sign contracts are canceling them in rapidly increasing numbers, some even willingly forfeiting their deposits. The mortgage lender is now refusing to fund this month's construction draw until the developer 'coughs up' $10,000,000 to cover cost overruns and rebalance the loan—though we think the timing of the mortgage lender's demand may have less to do with the revised project budget and sales projections, and more to do with it running out of cash to fund the remainder of the loan. In any event, the developer won't make the payment: its investors have long since bailed on the project, and if it weren't for its completion guaranty to the lenders, the developer might have walked away a long time ago too.

And as bad as it is, the situation could quickly get worse: the contractor has threatened to put a lien on the project if he isn't paid in the next two weeks.

The economy is in shambles. Nobody is safe. As mezzanine lender, we are at a crossroads; it's time to evaluate our options.

We made a $35,000,000 mezzanine loan on a condo development project, which is subordinate to a $100,000,000 mortgage loan. There is only $15,000,000 of sponsor equity in the deal, for a total capitalization of $150,000,000, at 90 percent leverage. When the loans closed, the mezzanine loan was fully funded and we sold a 49 percent senior participation interest to a private equity fund with which we had no prior relationship.

We retained a 51 percent junior interest in the mezzanine loan and agreed to act as servicer. At the time, the economy was good. We thought the hard work was done and we could sit back, wait for the project to sell out and watch sales proceeds roll in.

Now, we sometimes wishfully think, "If only there was a 'white knight'—or at least a reasonable 'vulture'—to swoop in and buy this project (or our loan) and get us out of this mess!" We'd even get out at a (slight) discount. But no one has come forward, and someone has to do something—and soon. To wait is to waste valuable time and opportunity. Unfortunately, the developer has too little "skin in the game" and won't be showing up with a suitcase full of cash. Neither will our participant; it isn't obligated to cough up a single cent under the participation agreement. As the junior participant and servicer of the mezzanine loan, we can either act or not act, but if we do not act, our participant can take over as servicer, and we would lose all approval rights over the mezzanine loan under the participation agreement. And once our cure period under the intercreditor agreement expires, the mortgage lender can foreclose, wiping us (and our participant) out completely.

DILIGENCE CHECKLIST

Note: This list is for reference only and is not intended to be complete. Consult legal counsel prior to entering into any term sheet or letter of intent.

- ☑ Obtain copies of all loan documents and loan files, including all intercreditor agreements, participations, correspondence, tax returns and financial reports.
- ☑ Determine current status of obligations under all loans, including payment history, outstanding principal balance, amount of interest, default interest and late or other fees, and amount of reserves and escrows.
- ☑ Identify organizational structure of all borrowers, guarantors and lenders, and obtain copies of all borrower organizational documents.
- ☑ Identify and prepare calendar of critical dates.
- ☑ Update title, UCC and departmental (violation) searches, confirm the property is in compliance with all laws. Obtain all documents of record against the property and all title insurance policies.
- ☑ Obtain all contracts and agreements affecting the property, including leases, management and construction agreements and the like.

As if the choice wasn't hard enough, there are still other decisions to be made in order to save our investment in the mezzanine loan—and we will need to convince our participant to agree with our proposed course of action. Our participation agreement establishes "major decisions" requiring the approval of both participants before the servicer can act, and our participant knows it's in its best interest not to cooperate with us: a deadlock between the participants triggers a "buy-sell" event, which, given the present fair market value of the project and our participant's senior position, would mean that we could be forced to buy out our participant at par or face losing our entire investment in the mezzanine loan.

But still, to what end? Even if we reach some sort of agreement with our participant about a course of action for the mezzanine loan, rebalance the mortgage loan and pay the contractor, the project is still a couple of months away from receiving a temporary certificate of occupancy and sales are behind schedule. If the condo units can be sold in this market, to *real* buyers who can obtain *real* financing, they won't sell at the prices at which the lenders originally underwrote the loans (especially if the public knows the project is in distress). If the market doesn't recover quickly, then sales proceeds will be insufficient to repay the mortgage loan before the scheduled maturity date, and the mortgage lender may end up owning the project through a foreclosure or a deed-in-lieu of foreclosure and we'd still get wiped out.

THE RESOLUTION

At Akin Gump Strauss Hauer & Feld LLP, we recently represented a mezzanine lender in a situation similar to the one described above. While there were many possible outcomes, we were able to help our client achieve the one that best suited its goals and risk profile. We would like to share the real-life resolution of the fact pattern presented above as an example of one such outcome.

Once our client decided that it did not want to walk away from its investment in the mezzanine loan, we got down to business and helped our client prioritize objectives, manage the different players involved in the project and achieve concrete results.

The first order of business was to protect the public image of the project. If the contractor were to have filed a lien against the project, we knew it would jeopardize condo sales. Knowing that the developer would not do so, our client immediately advanced the money to pay the contractor, which advance increased the unpaid principal balance of the mezzanine loan. We also ordered new title searches, just to make sure the project was otherwise free and clear of liens.

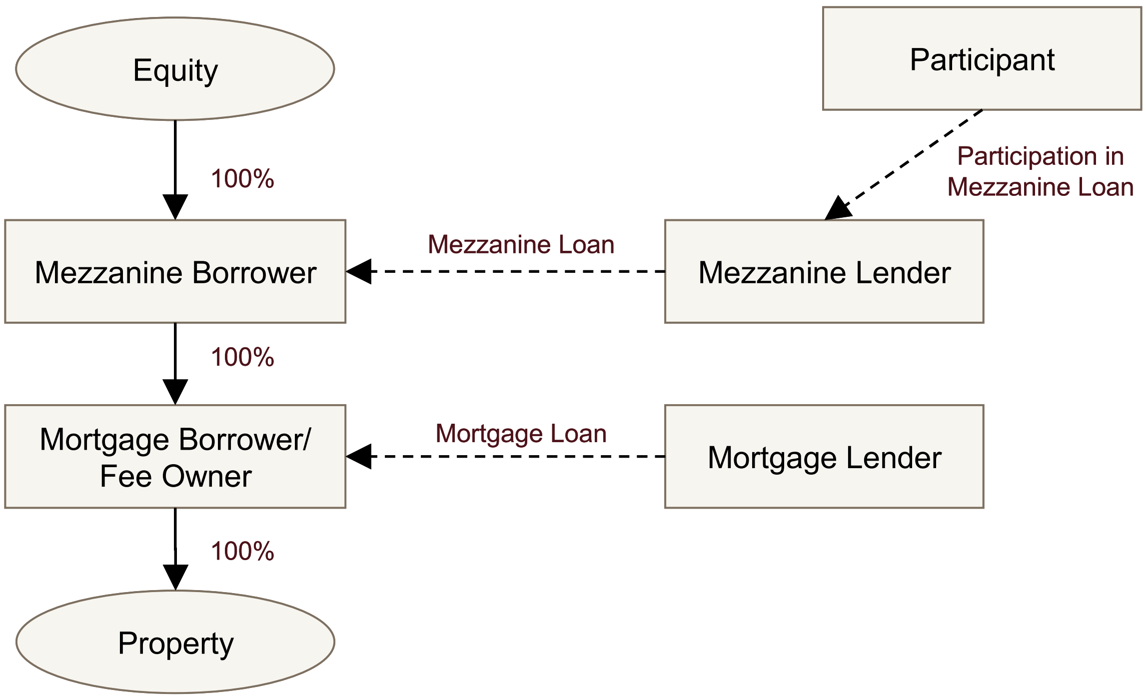
Next, our client needed to address the $10,000,000 payment past due to the mortgage lender. Our client had a 30-day cure period pursuant to its intercreditor agreement in order to make payments the developer had missed, before the mortgage lender could exercise its remedies against the project. However, under its participation agreement, our client was required to make the payment no later than 10 days prior to the expiration of that cure period or face both removal as the servicer of the mezzanine loan and loss of its approval rights.

> "Even in this market, a mezzanine lender still has considerable leverage in a debt restructuring negotiation—especially if it has capital available…"

Our client was not eager to make the entire cure payment itself and hoped its participant would, at least, make part of the payment or give it an extension of time in which to make the payment—at least enough time to obtain a commitment from the mortgage lender that it would grant an extension of the term of the mortgage loan in exchange for the cure payment and a commitment from the developer that it would cooperate and turn over the keys to the project without a foreclosure. Without these commitments, our client feared it would be throwing good money after bad.

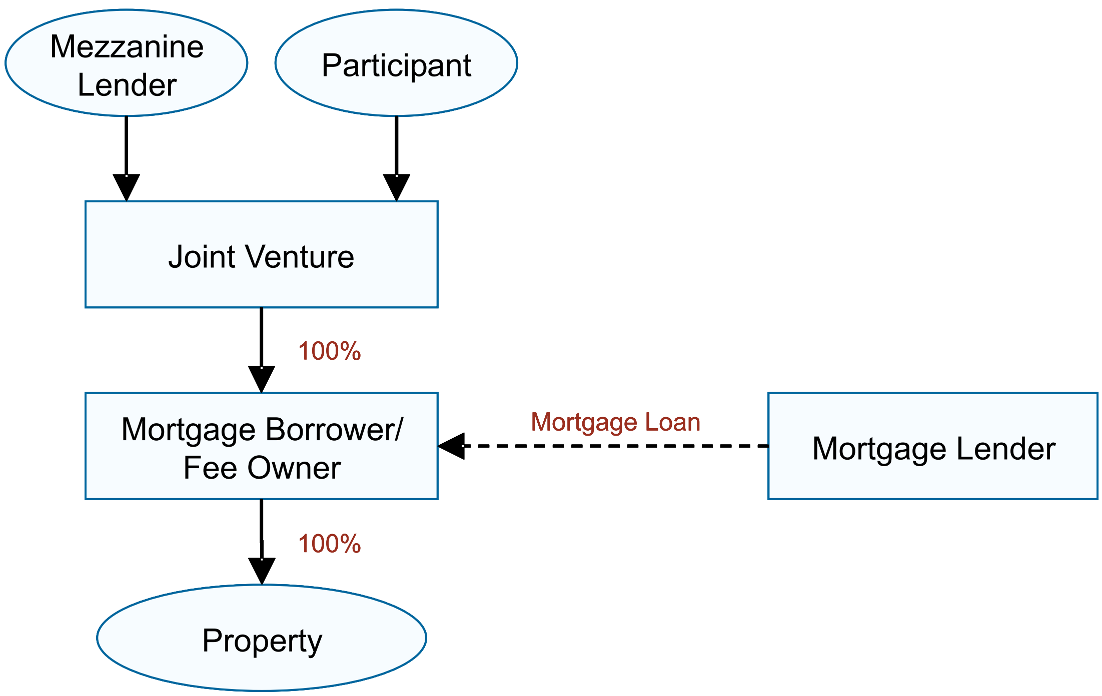
We marked deadlines on the calendar and immediately began negotiating with our client's participant, mortgage lender and developer. After hours of negotiating, we finally obtained the commitments we sought from both the mortgage lender and the developer. We learned that, even in this market, a mezzanine lender still has considerable leverage in a debt restructuring negotiation—especially if it has capital available—because no mortgage lender wants to have a defaulted loan on its books or need to pursue a foreclosure against a partially completed project, and no developer wants to be called on a guaranty or to have its name dragged through the press in connection with a foreclosure proceeding.

Pre-Workout Structure



Notwithstanding these two victories, our client's participant still would not budge: it would not contribute to the cure payment or extend the payment deadline in the participation agreement. There must have been enough potential upside in the project for it to insist that it would remove our client as servicer if it did not make the cure payment on time and in full, even though the participant would have to service the mezzanine loan and make the cure payment itself. Of course, there was another explanation: our client's participant was attempting to manufacture a "deadlock" in order to get bought out of the mezzanine loan. Either way, our client decided both that its approval rights and right to service the mezzanine loan were more important than winning this point and that it didn't want to buy out its participant. At the same time that it signed up a term sheet with the mortgage lender and got a commitment from the developer to a conveyance-in-lieu of foreclosure of the pledged ownership interests, our client made the $10,000,000 payment to the mortgage lender—net of the amount our client had already advanced to pay the contractor (which the mortgage lender would have otherwise advanced, but for the default by the developer in rebalancing the mortgage loan)—and cured the mortgage loan default.

Post-Workout Structure



It was now time to hammer out the details for all three transactions and draft (1) a modification to the mortgage loan with the mortgage lender, (2) a conveyance-in-lieu agreement with the developer and (3) a joint venture with our participant for the entity that would acquire title to the mezzanine loan collateral. Negotiations continued—and were dynamic—each paralleling the other, as all three were underway simultaneously. For example, the mortgage lender wanted our client to replenish reserves for interest and real estate taxes and agree to make periodic principal payments should sales proceeds be insufficient, in exchange for a two-year extension of the maturity date of the mortgage loan; it also wanted a replacement "bad boy" guaranty if the developer were no longer in control of the project. In exchange for its agreement to give our client the keys to the project, the developer wanted to be released from its guaranties under both the mortgage loan and the mezzanine loan because it would no longer be in control of the project. And our client's participant did not want to contribute any additional capital to the project or assume liability under any guaranties, unless it was in control of the project, whereas our client wanted greater control over the project and management- and economic-related concessions from its participant in the new joint venture in exchange for its exposure under any replacement "bad boy" guaranty it might be forced to give to the mortgage lender.

Clearly, everyone would not get everything they wanted, but, eventually, deals were struck with all parties. The conveyance-in-lieu agreement with the developer provided that the developer would transfer its ownership of the mezzanine loan collateral in exchange for a release from its "bad boy" guaranties under both the mortgage loan and the mezzanine loan. In addition, the developer agreed to (1) terminate all affiliate contracts relating to the project; (2) satisfy the monetary obligations of all contracts that had been entered into for the project without mezzanine lender's consent, if such contracts required mezzanine lender's consent under the mezzanine loan; (3) waive any claims the developer may have that would potentially set aside or invalidate the conveyance-in-lieu of foreclosure; (4) continue to pursue completion of the project and cooperate with, and provide assistance to, our client following the conveyance-in-lieu; and (5) maintain the conveyance-in-lieu in strict confidence to protect the project's public image.

Notwithstanding the conveyance-in-lieu, many of the mezzanine loan documents (other than the "bad boy" guaranty) remained in effect following the transaction, though most would not be enforced against the developer unless the conveyance-in-lieu agreement were set aside or invalidated. The completion guaranty and the environmental indemnity agreement, however, remained effective and enforceable against the developer to ensure both that the project would be completed and that our client would not be exposed to any environmental liability for the period in which the developer owned and was in control of the project.

Our client and its participant also entered into a joint venture agreement in accordance with the participation agreement to govern the joint venture that accepted title to the pledged ownership interests from the developer, and our client won a number of concessions from its participant, including the right to manage the project on a day-to-day basis, subject to enumerated matters for which our client's partner would have approval rights. This result was preferable to the requirement for co-management of the joint venture by the two participants set forth in the participation agreement and allowed for a less cumbersome decision-making process suitable to expedient decision-making in a quickly changing economic market. However, as a result of this concession, our client did agree to provide for all additional capital requirements of the joint venture, so long as it remained in day-to-day control of the project—including payments to be made under the mortgage loan—and to deliver a replacement "bad boy" guaranty to the mortgage lender following the conveyance-in-lieu of foreclosure.

"The transition from a lender/participant relationship to joint venture partners was not as straightforward as it would seem…"

Ironically, the negotiations with our client's participant were the hardest to bring to a mutually acceptable conclusion. The transition from a lender/participant relationship to joint venture partners was not as straightforward as it would seem—even though the participation agreement provided a general outline of the essential terms to govern the joint venture following a foreclosure or conveyance-in-lieu of foreclosure. Hindsight showed us that it would have been a futile effort to attempt to pre-negotiate the terms of the joint venture agreement at the time the participation agreement was executed because there were too many deal-specific, market-specific concerns addressed by the final joint venture agreement (and our client's interests may not have been best served by strict adherence to a pre-negotiated form).

And finally, following the consummation of the conveyance-in-lieu transaction, a modification of the mortgage loan became effective that provided for: (1) a two-year extension of the mortgage loan; (2) an increase in the mortgage loan's interest rate during the extension term; (3) a reduction in minimum sales prices for unsold condo units and exit fees payable at closing; (4) the establishment of principal reduction payments in lieu of loan rebalancing requirements to be made by the reconstituted borrower in the event unit sales were insufficient to meet periodic targets for repayment of the mortgage loan; (5) an acknowledgment by the senior lender that existing defaults had been cured or waived; (6) the amounts by which reserves for real estate taxes, interest and other carrying costs would be replenished during the extension term and the timing of such payments to the mortgage lender; and (7) releases of the existing guarantors from their "bad boy" guaranty in exchange for a replacement "bad boy" guaranty from our client. The mortgage loan modification provided the reconstituted borrower under the mortgage loan with greater flexibility to sell units at reduced prices throughout an extended period—without the threat of an impending foreclosure by the mortgage lender—and provided the mortgage lender with greater assurance that the mortgage loan would be repaid and project carrying costs would be satisfied, while compensating the mortgage lender for its extension of the mortgage loan term.

Even though the road was rocky, we reached agreement with the developer, our participant and the mortgage lender—but this time, without a press release or even a congratulatory drink. Our client had saved its investment for now, but the uncertainties of completing the project and selling the units remained.

It is important to note that the negotiated solution was appropriate for our client in this situation. Our strength as advisors came from our knowledge of the range of options, the potential pitfalls that can arise by choosing any given path and our dedication to listening to the unique concerns of the client. Loan restructuring is complex, and there is no cookie-cutter path to successfully restructuring a project once it has run into trouble.

ALTERNATIVE APPROACHES & STRATEGIES

The question always arises, what might the parties have done differently?

While no two deals are alike, the collective experience of lawyers in the distressed real estate asset services practice at Akin Gump Strauss Hauer & Feld LLP, who have represented borrowers, lenders and purchasers of distressed properties and distressed debt, gives us insight into some alternate approaches and strategies that might have been applied to the situation in which the parties to our case study found themselves, as well as their likely outcomes. Here, we consider those alternatives, the opportunities they create and the challenges they pose.

The Mezzanine Lender

In our case study, the mezzanine lender accepted a conveyance-in-lieu of the pledged ownership interests because it satisfied its risk profile and needs at the time. The success of the conveyance-in-lieu, however, depended on the cooperation of the borrower and guarantors, which, in this case, shared the mezzanine lender's goal of avoiding publicity and unnecessary expense. The mortgage lender was also willing to restructure its loan rather than face the prospect of taking back the project when the loan matured.

But what else might the mezzanine lender have done?

Purchasing the mortgage loan and the senior participant's interest in the mezzanine loan, for instance, would have afforded the mezzanine lender considerably more flexibility to restructure the debt with the borrower—without the pressure of complying with limited cure periods under the intercreditor and participation agreements—and also would have given the mezzanine lender the option to foreclose a mortgage, rather than only a pledge[1]. However, doing so would have been expensive: the intercreditor agreement and the participation agreement both provided that the mezzanine lender could only purchase the senior debt at par, rather than at current market prices, and the mortgage lender and senior participant refused to offer the mortgage lender a discount.

The mezzanine lender's other interests were speed and confidentiality. It wanted to get control of the project as quickly as possible and with as little publicity as possible. If a conveyance-in-lieu would have been impractical because the borrower and guarantors were uncooperative, or impossible because an investor in the borrower was unwilling (or unable) to grant its consent, then, so long as the mortgage lender was still willing to agree to a workout, a

[1] A mezzanine lender cannot accept a deed from the borrower without triggering the due-on-sale provisions under a mortgage. Therefore, it may only acquire the ownership interests in the existing mortgage borrower entity.

foreclosure of the pledged ownership interests in the mortgage borrower might have been a more attractive alternative to the mezzanine lender—especially if the foreclosure could be completed within the cure limits prescribed by the intercreditor agreement.

Foreclosures of mezzanine loans, which are governed by the Uniform Commercial Code (UCC), are significantly less time-consuming and less expensive than mortgage loan foreclosures. Depending on the jurisdiction in which the mortgaged property is located, mortgage loan foreclosures must proceed in court and can take several months (or more) to accomplish. A UCC foreclosure sale, on the other hand, takes place out of the courtroom and can be completed within as little as six weeks from the time the required UCC searches are performed and notices are sent. Notwithstanding the greater flexibility and shorter time frame, it is generally advisable for a mezzanine lender to undertake certain formalities, such as advertising the foreclosure sale in newspapers, inviting interested parties and potential bidders to attend and bid on the pledged ownership interests and providing adequate time and opportunity for these parties to review diligence materials related to the pledged ownership interests and the underlying property. The failure to do so may permit the borrower to raise challenges to a foreclosure sale, which may not ultimately prevent the foreclosure sale from occurring but could certainly slow the process. Nevertheless, complying with these formalities only adds to the mezzanine lender's expense and involves much more time and publicity than a conveyance-in-lieu.

In addition, a UCC foreclosure sale must be conducted in compliance with the intercreditor agreement and other applicable laws. The intercreditor agreement may restrict the class of purchasers to which pledged ownership interests can be sold (e.g., other banks, financial institutions or investment funds satisfying a minimum capitalization threshold), and require that the mezzanine lender or purchaser at a foreclosure sale deliver specified agreements, such as certifications and replacement guaranties, to the senior lender. If a mezzanine lender or purchaser fails to strictly comply with the provisions of the intercreditor agreement, then the senior lender could refuse to recognize the purchaser of the pledged ownership interests or be entitled to avoid the UCC foreclosure sale. Moreover, a UCC foreclosure sale conceivably falls within the definition of a "sale" for purposes of federal securities laws (however, if conducted in accordance with SEC guidance, the UCC foreclosure sale can generally be exempted from any registration requirements).

> "Foreclosure sales, which can be embarrassing for reputable borrowers and their principals, are not a lender's only possible remedy (or bargaining leverage) against uncooperative borrower parties in a loan default scenario."

Foreclosure sales, which can be embarrassing for reputable borrowers and their principals, are not a lender's only possible remedy (or bargaining leverage) against uncooperative borrower parties in a loan default scenario. A lender can also pursue remedies against guarantors if a loan is or has become, partially or wholly, recourse to the guarantors on account of a "bad boy", payment or completion guaranty. The mere threat of a lawsuit against a guarantor for a deficiency or to recoup a lender's other losses can be sufficient to bring the borrower parties back to the bargaining table. But when the threat of litigation fails, a lender should carefully consider its likelihood for recovery before it actually files a claim against the guarantors in court; if the guarantors are unable to satisfy a judgment against them, then a lawsuit only wastes valuable time and money and will increase a lender's total losses.

Take, for example, a lender who had made a mezzanine loan to fund the renovation of an office building and whose borrower had defaulted before the renovation project was complete, but had decided to put up a fight. The mezzanine lender had to foreclose upon the borrower's interest in a half-renovated office building—and in doing so, inherited a project burdened by numerous mechanics' liens and other claims for payment and subject to a defaulted construction loan.

Not too many lenders are interested in becoming, or are equipped to be, developers—and this particular mezzanine lender wanted to unload the project quickly, at minimal expense and with maximum recovery. It would not have been worthwhile for it to throw good money after bad to satisfy the mechanics' liens, or for it to attempt to cure existing construction loan defaults only to resume the renovation project itself and face a possible foreclosure later. So it foreclosed its pledge, put the mortgage borrower into bankruptcy in an attempt to delay an impending mortgage foreclosure (which it was able to do only because it had not been required to deliver a replacement "bad boy" guaranty to the construction lender under the intercreditor agreement as a condition to the foreclosure), and sold the half-renovated office building to pay off the construction loan. However, when all was said and done, there was very little left over after the sale for the mezzanine lender and its investors.

The mezzanine lender, which had previously learned that its borrower had made material misrepresentations in order to obtain the loan and that the guarantors had misappropriated loan proceeds for their own personal benefit, knew it had a claim against the guarantors under its "bad boy" guaranty and that it also had claims against the guarantors under a partial payment guaranty and a completion guaranty that it had obtained at the loan closing. The mezzanine lender sued and obtained judgments against the guarantors, but, by the time the judgments were rendered, the guarantors had squandered or hidden their assets and attempting to collect on the judgments became costly and further reduced the mezzanine lender's recovery.

Instead of suing the guarantors and spending more time and money chasing their assets, the mezzanine lender could have made the difficult choice of walking away from its loan completely, letting the mortgage lender foreclose. Alternatively, it could have sued the guarantors without foreclosing on the pledged ownership interests or attempted to sell the mezzanine loan at a steep discount to recoup as much as it could. Or, it might have attempted a workout with the borrower.

The Mortgage Lender

Mortgage lenders, typically banks, insurance companies and other financial institutions, while the most secure of all players in the debt-equity stack, are not exactly sitting pretty these days. They are hurting in this recession, too. For mortgage lenders facing a lack of confidence from their investors and the public and holding relatively illiquid and potentially toxic assets on their books, a defaulted mortgage loan can be a nightmare situation. Mortgage foreclosures are expensive and time-consuming, and, even if they can be avoided by a deed-in-lieu of foreclosure, at the end of the day, a mortgage lender will still become the owner of real estate and be forced both to pay real estate taxes and insurance premiums and manage (or hire a property manager for) the property. Most mortgage lenders aren't cut out to be property owners—it's not what they do—and, even if they are, the costs of property ownership and management add insult to injury when a mortgage lender faces the reality that the mortgaged property may be worth less than the unpaid principal balance of its loan.

But mortgage lenders are aware that opportunities exist even in troubled times, and a well-capitalized borrower that is unwilling to walk away from its investment, or a mezzanine lender that is not yet "out of the money," may be a blessing in disguise—and make a default their best friend.

Threatened with total loss in the event a mortgage lender forecloses or sues on its guaranties, borrowers and guarantors—and even mezzanine lenders—may be willing to engage in work-outs with mortgage lenders in order to keep the mortgaged property for now, or at least to forestall a foreclosure a little longer, in order to attempt to turn a troubled property around. But a forbearance or workout isn't always a fail-safe approach and may only defer the inevitable. Some real estate assets can't be turned around or repositioned, not in this market, and not even with a new "concept" or management or revised budget. Notwithstanding, there may be little disincentive for a lender to at least consider a borrower's proposal for a workout or loan restructuring.

Other lenders, however, will prefer greater certainty about repayment, even if that means repayment at a loss—either because they need cash now or they do not want to be a property owner later—and, so, will agree to discounted repayments from borrowers or market their loans for sale at potentially steep discounts to investors interested in "loan-to-own" opportunities. After all, what is one person's trash may be another person's treasure.

In its simplest form, when not complicated by complex pooling and servicing arrangements or participation agreements, trading debt can be quick and easy: a short period for the purchaser and its attorneys to review loan documents and underwriting materials, update title and run searches on the loan parties, negotiate a purchase and sale agreement and fund the purchase price. Let the buyer beware: a purchaser must understand what it's buying and must weigh the discount against the time, effort and expense involved in workout negotiations, the foreclosure process, potential litigation with borrowers and guarantors and then ownership and management of a distressed property.

> "Let the buyer beware: a purchaser must understand what it's buying and must weigh the discount against the time, effort and expense involved in workout negotiations, the foreclosure process.…"

Many investors are actively searching for loan-to-own opportunities and are focused on purchasing mortgage debt, rather than mezzanine debt, because many mezzanine loans are too underwater to be worthwhile. In addition, the mortgage foreclosure process, while longer and costlier than the UCC foreclosure process, affords investors the added advantage that, following the foreclosure, the loan purchaser will own the property free and clear of subordinate liens and encumbrances. So, when a potential purchaser encounters a defaulted or near-defaulted mortgage loan in which the borrower (and any mezzanine lender) is "out of the money" and unable to refinance or infuse additional capital into the property from new or existing investors, and the debt is either offered at a steep enough discount or the mortgaged property is capable of being repositioned, a deal may be viable.

Mortgage loan purchasers may then either attempt to restructure loans with borrowers, guarantors and/or any mezzanine lenders or forego such negotiations and exercise their remedies. If a loan purchaser elects a workout, or permits a repayment or refinance of the loan at a discount, then, so long as the proceeds of the repayment or refinance exceed the purchaser's basis in the debt, the loan purchase has proven to be a good investment. But, if the purchaser, instead, forecloses or accepts a deed-in-lieu, then it acquires the mortgaged property for substantially less than it might have otherwise done in a direct purchase from the borrower.

It is important to note that, if a mortgage lender or loan purchaser accepts a deed-in-lieu of foreclosure from a borrower, it accepts title to the mortgaged property subject to all subordinate liens against the mortgaged property (including second mortgages and mechanics' liens), which are then of record. Even so, a mortgage lender or loan purchaser may accept a deed-in-lieu of foreclosure in the name of a designee and thereafter foreclose its mortgage in an attempt to take advantage of the speed and ease of a deed-in-lieu transaction without losing the benefits of the foreclosure process. Depending on the jurisdiction, however, the two-step process may not be respected. Some courts have concluded that the mortgage is merged with the deed-in-lieu and no longer effective as a lien against the mortgaged property, notwithstanding that the designee accepting the deed-in-lieu is an entity separate from the mortgage lender or loan purchaser. Other jurisdictions may respect the two-step process but provide that the acceptance of the deed-in-lieu and a foreclosure constitute separate taxable events for transfer tax purposes, making the cost of the two-step process potentially prohibitive.

Additionally, a mortgage lender and loan purchaser should be aware that New York, among other states, has an "election of remedies" rule, which limits the ability of a mortgage lender to pursue both a mortgage foreclosure and an enforcement against the borrower or guarantors at the same time. Generally, under this rule, a mortgage lender must choose between proceeding against the borrower and foreclosing the mortgage, or suing the guarantors. Where an election of remedies is required, a mortgage lender typically will foreclose its mortgage first and, if the value of the mortgaged property is less than the unpaid principal balance of the mortgage loan, then seek a deficiency judgment against the guarantors, to the extent of the deficiency, but only if there is liability under a payment, completion or “bad boy” guaranty. A mortgage lender may alternatively choose to sue the guarantors without foreclosing its mortgage, especially if the mortgaged property has declined substantially in value or would be too costly to own or manage and the guarantors have “deep pockets.”

The Borrower

Notwithstanding that the borrower is always in the first-loss position, a borrower doesn’t need to automatically throw in the towel just because its investment is underwater or its loan is in default. A borrower may yet save its investments and live to see another day—but needs to play its cards right by being proactive and creative. In times such as these, the traditional strategies, e.g., selling, refinancing or recapitalizing real estate, may not be available, no matter how earnest the borrower’s intentions or diligent its efforts.

First, a borrower needs to know whether its lenders are gun-shy or trigger-happy about exercising their remedies. A borrower whose lenders are averse to foreclosing can be proactive, exploit its lenders’ unwillingness and win concessions, permitting it additional time and leeway to turn its investment around.

“A borrower whose lenders are averse to foreclosing can be proactive, exploit its lenders’ unwillingness and win concessions, permitting it additional time and leeway to turn its investment around.”

For example, in our case study, the borrower’s original business plan called for completion of the project and sale of the condominium units to pay off the mortgage and mezzanine loans. But in a down market, the borrower’s effort to sell condominium units was futile: there were too few buyers willing to pay the prices needed in order to repay the construction loans, and even those few buyers were having difficulty obtaining financing to purchase their units. Rather than giving up and turning the keys over to the mezzanine lender, the borrower could have abandoned its original business plan and repositioned the project as a rental apartment building, requesting that the lenders convert the construction loans to term loans and extend the maturity dates—potentially resulting in a win-win situation for all parties involved.

Lenders who don’t want to become property owners or sacrifice their investments might have listened, especially if rental occupancy rates and market rents supported the borrower’s revised business plan and projected absorption rates for condominium units in the local market demonstrated that the lenders would encounter the same problems if they foreclosed and attempted to sell the condominium units themselves.

The borrower in our case study might have also attempted to outsmart its lenders. Recall that the particular default under the mortgage loan involved cost overruns and insufficient condominium sales that triggered a rebalancing covenant under the mortgage loan and required a substantial payment to the mortgage lender in order to cure the default. Had the borrower or any of its affiliates had the funds to do so, and there were no restrictions preventing it, instead of making the payment, they might have purchased enough condominium units at the minimum release prices to generate proceeds sufficient to rebalance the mortgage loan. The mortgage loan would then have been performing again, and the number of condominium units serving as collateral for the mortgage loan would have also been reduced. Even if the mortgage were later foreclosed, the borrower (or its affiliates) would own—and be able to resell or lease—the condominium units it had purchased.

> "A savvy borrower might also have used disagreements among its co-lenders and their loan participants as leverage."

A savvy borrower might also have used disagreements among its co-lenders and their loan participants as leverage. If a borrower has access to additional capital but doesn't want to throw good money after bad (especially when its lenders might ultimately foreclose), and also knows that some of its co-lenders do not want to undertake the burden of property ownership and would be willing to accept a discounted repayment in order to walk away from the loan entirely, the borrower can offer to buy out the interests of some of the co-lenders (whether directly or through affiliates, or structured as assignments or participations of their respective interests). By doing so, a borrower may successfully neutralize the faction opposed to a discounted repayment of the loan, distract its co-lenders or create enough disagreement among them to forestall any remedial action or motivate them to return to the negotiating table to consider the borrower's workout proposal. Even if the co-lenders ultimately do foreclose the mortgaged property, a borrower may nevertheless acquire enough of an interest in the loans to maintain an interest in the property following the foreclosure.

Similarly, a borrower may team up with one or more of its junior lenders in an attempt to protect or, at least preserve, their respective investments, particularly if none of them individually has the capital to buy or pay off the existing debt, but collectively they would be able to do so—or make cure payments or replenish reserves—to prevent or forestall a foreclosure.

For example, borrower's principals may offer to have its mezzanine lender admitted as an additional owner of the mortgage borrower and provide the mezzanine lender with a preferred return on its contribution to the mortgage borrower (i.e., the unpaid principal balance of the mezzanine loan) in exchange for its "forgiveness" of debt. The conversion of a mezzanine loan to preferred equity permits the borrower's original principals to continue to have an ownership interest in the mortgaged property and entitles them to residual profits (a so-called "hope certificate") in the event the mortgaged property is successfully repositioned or market conditions improve—something they would certainly forfeit if the mezzanine lender instead opted to foreclose. This strategy also permits the mezzanine lender to preserve its original investment and return, without having to incur the effort, expense and publicity attendant on a foreclosure of its pledge.

Alternatively, if a mezzanine lender has acknowledged that it is "out of the money" and is unwilling to exercise its rights under the intercreditor agreement to either cure mortgage loan defaults or purchase the mortgage loan in order to forestall or prevent a foreclosure of the mortgage, then that same savvy borrower might approach its mortgage lender and attempt to cut a deal behind its mezzanine lender's back, especially if the mortgage lender lacks property management experience and might be hesitant to otherwise foreclose its mortgage.

In this example, principals or affiliates of the borrower and mortgage lender may agree to form a venture to purchase the mortgaged property at the foreclosure sale, free and clear of all subordinate liens (including the mezzanine loans) and thereafter manage and operate the property according to the terms of the venture. While risky and potentially open to challenge by the mezzanine lender, the strategy at least provides the borrower with the opportunity to preserve its interest in the mortgaged property by exploiting the mortgage lender's reticence to becoming a property owner.

Only if these and other creative solutions seem unlikely to succeed, or a borrower has no appetite for the risks involved in such strategies, or if the potential rewards from such approaches appear too remote, should a borrower consider its last resort: simply to walk away and turn the keys over to its lenders.

In offering to do so, a borrower would probably be expecting too much if it asked its lender for a full and unconditional release from the loan; on account of bankruptcy and fraudulent conveyance concerns, a lender will likely agree only to "suspend" the borrower's obligations with respect to the debt, and then only for so long as the deed- or conveyance-in-lieu transaction remains effective and has not been set aside or rendered void.

Nevertheless, lenders may be inclined to grant some concessions to the loan parties if the borrower voluntarily deeds or conveys its interest in the collateral to the lender, thereby sparing the lender the time and expense it would incur on account of a foreclosure proceeding. Generally, however, a lender's willingness to agree to concessions will depend on the facts and circumstances surrounding the loan and collateral, because a lender will not agree to put itself in a materially worse position as the result of a deed- or conveyance-in-lieu arrangement than it might have been in if it had, instead, foreclosed. In our experience, lenders are generally willing to release guarantors from liability arising under "bad boy" guaranties and environmental indemnity agreements for acts or occurrences arising after a deed- or conveyance-in-lieu transaction, but not for acts or occurrences arising beforehand. A lender will likely also be unwilling to release a guarantor from a completion guaranty if it is forced to accept title to a construction, renovation or conversion project that has not yet been completed. To do otherwise would potentially expose the lender to liabilities of an unknown nature and extent that would arise solely on account of the acts or omissions of prior owners of the property.

Workouts and restructurings of distressed debt and distressed properties involve dynamic negotiations among parties with vastly different resources, risk profiles and bargaining leverage. While no two work-outs or restructurings will necessarily follow the same pattern or protocol—or even have the same result—they do provide their participants with alternatives and opportunities that are context-specific and require flexibility, creativity and a willingness to be proactive.

We hope these materials have provided you with some insight into the alternatives, remedies and opportunities available to real estate investors navigating the present market conditions. We look forward to working with you to realize your goals and objectives in the distressed debt and distressed properties markets.

GLOSSARY

"Bad boy" guaranty—a guaranty made by one or more of a borrower's principals to a lender in order to protect such lender against losses resulting from bad faith acts of the borrower, such as fraud, the misappropriation of funds, unauthorized transfers of collateral and bankruptcy filings. "Bad boy" guaranties (also known as "***springing guaranties***") are generally required by a lender when its loan to a borrower is "non-recourse"—meaning that the borrower is not personally liable to the lender for losses resulting from its bad faith acts and the lender's recovery is limited to the value of the collateral.

Completion guaranty—a guaranty made by one or more of a borrower's principals to a lender, whereby the guarantor(s) agree(s) to undertake completion of construction or renovation of a project and to pay for construction costs in the event the borrower fails to do so. Completion guaranties are generally required by a lender when its loan to a borrower will fund the construction or renovation of a project.

Conveyance-in-lieu of foreclosure—a transaction in which a debtor voluntarily transfers title to the collateral securing a debt to its lender in order to satisfy such debt, usually following the occurrence of an event of default. A "conveyance-in-lieu" is generally faster and less costly than a foreclosure but, unlike a foreclosure, does not extinguish subordinate liens against the collateral. A conveyance-in-lieu transaction in which the collateral securing the debt is real estate is generally referred to as a "***deed-in-lieu of foreclosure***" transaction. Note, however, that, in a conveyance-in-lieu of foreclosure involving ownership interests in an entity, such as in a mezzanine loan, the transferee to which the collateral is transferred acquires the collateral subject to both subordinate liens against the collateral, as well as the liabilities (e.g., liens, litigation, mortgages, third party agreements, etc.) of the acquired entity and its subsidiaries.

Cure—following a borrower's default, payment or performance by such borrower—or by another party on such borrower's behalf (e.g., a subordinate lender)—that corrects or eliminates the default. Loan documents may provide that a borrower has a period in which to cure a default (known as a "***cure period***") before a lender declares that an "event of default" has occurred and/or begins to exercise its remedies on account of the event of default. An intercreditor agreement between lenders may grant a mezzanine lender with an additional cure period following the occurrence of an event of default, before which a mortgage lender is prohibited from exercising its remedies.

Forbearance— following an event of default, an agreement by a lender to refrain from enforcing its remedies under the loan documents for a specified period of time during which the borrower attempts to cure the event of default or the borrower and lender attempt to negotiate a restructuring of the loan.

Foreclosure—a legal procedure whereby collateral securing a debt is sold to satisfy such debt following the occurrence of an event of default. In a foreclosure, all subordinate liens against the collateral are extinguished, and title to the collateral is transferred to the holder of the debt (or its nominee) or a third-party purchaser of the collateral. Foreclosures of mortgages against real estate are governed by state real property laws, and foreclosures of pledges of ownership interests are governed by a state's Uniform Commercial Code.

Fraudulent conveyance—a transfer by a borrower of its property for little or no consideration (a) at a time when the borrower was insolvent, (b) at a time when the borrower believed that it would not be able to meet its obligations under the contracts to which it is a party, (c) that renders the borrower's capital unreasonably small or (d) that is made with the actual intent to hinder, delay or defraud creditors.

Intercreditor agreement—an agreement between lenders making loans for the same project or to related borrowers that, among other things, sets forth the relative priority of the rights and remedies of such lenders with respect to the collateral (or the proceeds thereof, e.g., condemnation awards, insurance proceeds, proceeds of sales) or against the borrower(s) and guarantor(s) for such loans. For example, an intercreditor agreement generally will provide that a mortgage lender may not exercise its remedies against a borrower unless and until a mezzanine lender has both had an opportunity to cure the defaults of a borrower and failed to do so within that specified cure period.

Lien—a claim by one party against the property of another as security for a debt or obligation. A lien does not transfer title to the property to the lienholder unless the debt or obligation remains unsatisfied beyond applicable cure periods and the lienholder forecloses the lien against the property. Liens may be granted pursuant to contract, such as a mortgage or pledge, or permitted by statute, such as a mechanic's lien against real property for unpaid work to contractors or materialmen, and may require filings in public records to put other interested parties on notice of the claim against the property.

Major decisions—material decisions regarding the administration of a loan that cannot be made solely by the loan's servicer and that require the consent of a majority or all of the participants pursuant to a participation agreement. Major decisions may include material modifications to loan documents, increases in the amount of a loan, waivers relating to the amounts or timing of payments of interest or principal, the release of collateral and the assertion of remedies against a borrower or guarantor following the occurrence of an event of default.

Mezzanine lender—a lender that has made a loan (a "***mezzanine loan***") secured by a borrower's (a "***mezzanine borrower***") ownership interest in a subsidiary (generally, an entity that directly or indirectly owns real property that is collateral for a mortgage loan). Following the occurrence of an event of default by a mezzanine borrower, a mezzanine lender's remedies include foreclosure of the pledge against the collateral for the mezzanine loan or acceptance of a conveyance-in-lieu of foreclosure, in which event, the mezzanine lender (or its designee) would acquire ownership interests in an entity that directly or indirectly owns real property subject to a mortgage loan.

Mortgage lender—a lender that has made a loan (a "***mortgage loan***") secured by the real property of a borrower (a "***mortgage borrower***"). Following the occurrence of an event of default by a mortgage borrower, a mortgage lender's remedies include foreclosure of the mortgage against the collateral for the mortgage loan or acceptance of a deed-in-lieu of foreclosure, in which event, the mortgage lender (or its designee) would acquire ownership of real property.

Participation interest—an interest in a loan. Each "***participant***" that acquires a participation interest in a loan is required to fund its proportionate share of loan advances and also has a right to receive a proportionate share of the interest and principal repaid on such loan. The rights of the participants in a loan are governed by a "***participation agreement***" that establishes, among other things, the relative priority of the rights of the participants (i.e., if the participants' relationship is senior-subordinate or pari passu), the participant or other party that will act as "***servicer***" for the loan, the terms upon which the loan is administered, major decisions requiring the consent of a majority or all of the participants and restrictions on the transfer of participation interests.

Rebalancing—cash infusions, payments or other adjustments required by a lender from a borrower, oftentimes as a result of increases in construction or carrying costs or decreases in the appraised value of collateral, to achieve debt-to-equity or loan-to-value ratios required by such lender in the loan documents.

Scheduled maturity date—the date on which a loan and all obligations thereunder must be satisfied in full.

Servicer—the entity that administers a loan on behalf of a lender or loan participants pursuant to a participation agreement or other servicing arrangement. If a loan has not been assigned or participated, the originating lender may oftentimes service the loan itself.

Sponsor equity—the amount or value of money and other property (other than borrowed money) contributed by investors to a project.

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