Loans in Distress and Default 18

This chapter reviews the options and strategies that a mortgage lender (the "Lender") might pursue when it believes that a real estate mortgage loan (the "Loan") will soon go into default, either because the borrower under the loan (the "Borrower") will fail to pay the loan upon maturity or because the borrower will suffer financial distress before then.

The discussion begins by describing steps the lender can proactively take, or at least consider taking, to prepare for battle, to gain control of the mortgaged property and its income stream as early as possible, and to maximize and understand its options.

This chapter also includes a menu of less confrontational possibilities a lender might ultimately prefer to take to "work out" the loan, either when it has gone into default or when the lender sees an obvious default looming ahead. Each of these possibilities assumes the borrower and the lender still have a constructive relationship and the lender still has confidence in the borrower.

This chapter considers defaults and workouts as a generic matter. Any particular comments here might not apply to any particular loan, and any particular loan will always raise its own issues. The terms of the governing documents will be extremely important — particularly the degree to which any principals of the borrower are personally liable for the loan or for any "non-recourse carveouts." The lender should always involve counsel in forming any strategy to deal with a loan. If the lender has a servicer for the loan, the servicer would perform some of the tasks this chapter suggests, depending on the details of the servicing arrangement. The tasks themselves will not change much.

Parts of this chapter consider the very common case where a loan is secured by multiple properties, including some in California and some in other states. This chapter does not consider construction loans (which raise their own morass of issues and practical problems) or hotel, motel, or lodging loans (whose unique issues are suggested in Chapters 12 and 13).

The issues and options in dealing with defaulted loans are potentially open-ended — far more varied, complex, and interesting than the issues that arise in closing a loan in the first instance. This chapter therefore attempts to cover only the major issues and choices, and does not cover everything that could possibly apply.

Overall Strategy; Some Preliminary Questions to Answer

In establishing a strategy for any distressed or defaulted loan, a lender should begin by asking a few questions and thinking about some fundamental strategic issues. The answers to those questions, and the lender's fundamental strategic preferences, will collectively define the context for everything that follows. These questions should be asked (and where possible answered), and this strategic analysis performed, at the beginning of the process of dealing with any defaulted loan. These questions and issues relate as much (or more) to the lender's internal agenda and priorities as they do to the details of the particular loan. The former questions and issues are at least as important as the latter.

Timing

As soon as a maturity default has occurred, a lender should normally initiate the earliest possible enforcement of all (or at least some) of its available rights and remedies, subject to concerns discussed below about procedural restrictions in California and potentially other states. Borrowers typically ignore threats. Merely being indecisive in exercising remedies may itself create issues later, by inviting the borrower to assert claims of "waiver" and other surprises. The best way to catch a borrower's attention is to act decisively, aggressively, quickly, and unambiguously. Nothing stops the parties from negotiating even while fighting (although those negotiations should, of course, be preceded by a preworkout agreement, as discussed below).

Therefore, when a lender anticipates a loan will go into default the lender should be ready to begin enforcing at least some of its remedies almost immediately.

A borrower will almost always try to delay any exercise of the lender's remedies, because mere delay helps the typical borrower achieve its goal of holding onto the mortgaged property and its income stream for as long as possible — perhaps merely trying to "hang on for a better day." To the extent that the lender delays exercising its remedies, the lender helps the borrower achieve the borrower's single most important goal.

Lender Liability

In any discussion of a defaulted loan, one question that arises again and again is the risk of "lender liability." This risk is often overstated, based perhaps on a few dramatic cases where particular lenders faced significant liability based on particular facts and history of a particular loan.

Free-floating anxiety about lender liability often leads lenders to tiptoe on eggshells, unnecessarily, in dealing with borrowers in default. In most of the litigation where a lender incurred "lender liability," the lender had done something egregious and outrageous such as taking control of the borrower in a way that was clearly unreasonable and inappropriate in 20/20 hindsight, or making promises or assurances but not living up to them ("leading the borrower down the primrose path"), or somehow "tricking" the borrower.

Normal enforcement activities, even if the borrower does not like them, should not create material exposure, although in modern America anyone can allege anything in court and often does.

To some degree, "*lender liability*" is old news, a legal trend that has run its course. Most of the cases date back at least a few years. More recently, the courts have not been enthusiastic about pioneering expansions of "*lender liability.*" Courts seem to have realized that in the borrower-lender relationship, when a loan goes into default, the culpable party just might be the borrower that failed to pay rather than the lender that expected to be repaid and dared to exercise its remedies and put pressure on the borrower.

In enforcing a loan, any lender should try to demonstrate some degree of "*good faith and fair dealing*" — notice, communications, consistency, openness, lack of "*trickery,*" etc. — but fear of "lender liability" should not be a lender's overriding concern. The following are a few suggestions to prevent "*lender liability*":

- The lender should be particularly careful about any oral communications, as these will be misconstrued and inaccurately remembered. That fact underscores the importance of a "preworkout agreement" before any discussions begin, and clear written communications where possible. If the parties meet, the lender should consider distributing brief notes on the meeting. The main function of those notes is not really to summarize the meeting but to emphasize, again, the nonbinding and preliminary nature of any discussions.
- Lenders should avoid taking actions that might be construed as "taking advantage" of information or introductions that the borrower provides. For example, if the borrower introduces the lender to a possible buyer of the mortgaged property, the lender should not then immediately freeze the borrower out of the discussions and negotiate direct arrangements with the proposed buyer.
- A lender should not precipitously change course, such as by suddenly enforcing all loan documents in accordance with their literal terms after having done nothing for many months. Give the borrower some notice — not necessarily very much notice — before changing the rules.
- If a lender wears two hats (such as holding a mortgage and holding a passive equity position in the borrower), the lender may want to pay somewhat greater attention to these issues. Any such lender should go out of its way to clarify the role it plays at each point in the discussions. And the lender should be careful about using one of its roles to give it extra leverage in another role. (For example, if a lender's affiliate is also a limited partner of the borrower, that limited partner should not lightly vote against a transaction that would allow the borrower to repay the lender's mortgage loan.)
- If the borrower makes any proposal regarding the mortgaged property, the lender should try to show that the lender considered the proposal and, ideally, that the lender's response to it was reasoned, reasonable, and defensible. On a practical level, remember that the borrower usually does know more about the mortgaged property than the lender, and any

borrower proposal will usually merit at least some consideration. Try to show that the lender did provide such consideration.

- Remember that most internal "confidential" memos are not confidential at all in litigation. The lender's personnel should never write down a comment in a memo — or in an email message — if that comment might embarrass the lender in any future litigation with the borrower. Any written communications, including email, should be written with litigation in mind. In effect, everyone on the lender's staff must learn to think like a lawyer, recognizing that they leave behind them a trail of potential evidence every time they put pen to paper or press the "Send" button on their computer. Communications with counsel should be protected from disclosure, but there are exceptions and dropped balls here too.
- In particular, a lender should beware of establishing a written record of its business goals or motivations, because the borrower can and will try to use that written record to establish that the lender acted for improper reasons. For example, if the lender indicates it simply wants to get a loan off its balance sheet, the borrower may point to that statement as evidence of why the lender acted "unreasonably."

Notwithstanding these suggestions, if a lender behaves in a reasonably businesslike way and does not trick or take advantage of the borrower, likelihood of "lender liability" should remain rather low. Involvement of competent counsel from the beginning will usually help reduce the risk further.

Co-Lenders

When a loan gets into trouble, the negotiations will be simpler and quicker if one lender holds the loan without participants or other co-lenders. To the extent that this is not the case, the lender should consider any requirements about reporting, consents, consultation, or approvals. The governing documents may establish notice periods and buy-out rights as well, which the lender should consider as part of its analysis. These requirements may in practice prove to be counterintuitive and burdensome, and must be identified as early as possible. The lender should consider involving any necessary third parties in the lender's early decision process and analysis (even in such "minor details" as approving the form of preworkout agreement to be entered into with the borrower), rather than merely going to those co-lenders at the last minute to seek approval of a "done deal." Early involvement will probably produce greater cooperation down the road.

Other Charges

Once a loan goes into default and an "event of default" exists (i.e., the borrower failed to cure the particular default within whatever cure period applies), the entire loan will typically begin to bear interest at the default rate — usually anywhere from 2% to 5% per annum over the contract rate. For that and other reasons, the lender should, as early as possible, give the

borrower unequivocal notice of any default and subsequent event of default and any resulting change in the interest rate as soon as it occurs. The loan documents also usually allow the lender to require the borrower to reimburse attorneys' fees, costs of collection, and so on, all within a short period after the lender's demand. A lender should usually make such demands as frequently as is reasonable.

Ownership

Is the lender in a position to own this asset? If the lender owned this asset, what would the lender do with it? Resell it quickly? Redevelop or reposition it? Does the lender have people who can undertake such a project? Does the lender have a concept for how the mortgaged property might be repositioned, redeveloped, or broken up to create value that the borrower failed to create?

Can the lender stand the thought of operating the mortgaged property? Does the lender have the necessary expertise, or can the lender easily buy the expertise? A lender should think of the mortgaged property as a real estate investment, in which the lender's cost equals the likely next higher bid (below the lender's) for the mortgaged property at a foreclosure sale. Would the lender want to make this investment for that cost?

Appetite for Foreclosure, etc.

What is the lender's overall agenda regarding this loan and defaulted loans generally? Does the lender want to avoid foreclosures, or this foreclosure particularly? What is the lender's time horizon? Is this particular lender in the "loan-to-own" business?

Accounting

As a matter of internal accounting, what goals and timing does the lender want to achieve regarding this asset? Has the lender fully reserved for it? What timing works best for realization of any further loss from this asset?

Internal Approvals

How does the lender's internal approval process work for any resolution of a particular loan? Can the lender's personnel obtain a preliminary approval in concept, to save time once the deal is finally signed?

Due Diligence; Information Gathering

When a lender sees a default ahead, the lender's first requirement is to obtain as much information about the mortgaged property and the loan as possible, because information shapes strategies and decisions. The following is an incomplete list of information that any lender will usually want to obtain early in the process. Any particular loan will usually raise other issues and require other information.

Loan Document Audit

As a very early step in dealing with any distressed or defaulted loan, the lender should, with help from its counsel, carefully review all the loan documents, amendments, side letters, and correspondence (even emails), to identify as early as possible any possible problems or opportunities in the documents and the mortgaged property, such as missing filings and deliveries; timing and notice requirements; potential opportunities to assert personal liability; vagueness or uncertainty; special borrower rights or counterintuitive notice requirements; possible issues about perfection, waivers, lender liability, gaps, problems, omissions, inaccuracies in collateral descriptions (e.g., do the documents refer to the correct account numbers?), "unreasonable conduct" by the lender, and so on; discretionary pro-active steps, if any, the lender can take in the face of upcoming problems; and agreements with third parties (e.g., intercreditor agreements or servicing agreements) that may limit the lender's flexibility or require the lender to take certain actions.

Are all the documents signed? Do they have any blanks, gaps, or missing exhibits? Are any terms of the documents uncertain or still under negotiation?

Although the lender may prefer to avoid the potential legal fees of performing an audit of loan documents, such an audit will almost always be highly worthwhile. It is best performed early, because if the lender has some lead time, the lender may be able to solve problems and prevent them from becoming disasters. Early knowledge will also help the lender know what to ask for in exchange for any early concessions or accommodations to the borrower (such as a brief "standstill" in enforcing the loan, if this otherwise makes sense).

Whether and when to initiate a loan document audit raises issues of "cost-benefit," which will vary from loan to loan and will always depend on all the circumstances of the particular loan.

Valuation

If this loan goes into default, the lender will need to have a good sense of what the mortgaged property is worth — today — even if on some level the lender doesn't really want to know. This one fact, i.e., the current accurate value of the mortgaged property, determines strategy, tactics, leverage, and almost everything else in how the lender deals with the borrower. If the borrower files bankruptcy, the value of the mortgaged property will dramatically affect the lender's rights and leverage starting almost from the first day of the bankruptcy proceeding.

The lender should therefore consider ordering appraisals or informal appraisal updates for the mortgaged property. These orders should be placed by counsel in the hope (but not assurance) that doing so will help preserve the attorney-client privilege.

Appraisals are often incendiary, though. They should be handled with care. For better or worse, if/when the loan goes into litigation, the courts may regard an appraisal as almost an admission by the lender of the value of the mortgaged property. In reality, of course, an appraisal is nothing more than an educated assessment (or guess) of value, driven almost entirely by whatever assumptions the appraiser chooses to use. To limit the potential evidentiary value of any information a lender has regarding the value of the mortgaged property, the lender may prefer to obtain an oral appraisal update or other informal oral advice rather than a piece of paper that will need to be delivered to the borrower in litigation.

Assessment of Borrower

Perhaps as important as the valuation of the mortgaged property is the lender's valuation of the borrower. Is this a good borrower with a bad project, or a bad borrower? Is the borrower more or less capable than the lender of salvaging the mortgaged property and extricating both the borrower and the lender from an awkward situation? Does the lender have other relationships that could color the borrower's treatment of this mortgaged property?

Original Loan Documents

A lender should confirm that it has the original loan documents and that it knows where they are. Those documents may be needed in a foreclosure. If they are missing, the lender may be able to arrange replacements if the problem is identified early enough.

In particular, if the lender holds any letters of credit backing the loan — or otherwise relating to the loan in any way — the lender should determine the location of those letters of credit and recheck their expiry dates (a process that the lender should have been performing routinely all along).

Financial Statements and Reports

As a loan heads toward default, the lender should review its files to see whether it has current financial information about the mortgaged property. Often a borrower will stop delivering timely financial reports as the first sign of trouble with the mortgaged property. As the loan nears default, however, it may be too late to obtain any further cooperation from the borrower, depending on whether the borrower believes cooperation is in its best interest. But the lender may want to try. The lender should at least have a sense of what's missing, if anything.

Title Reports

Regardless of which path a lender ultimately takes regarding any troubled loan, the lender should obtain (or have its counsel obtain) updated title information about the mortgaged property as soon as possible. That information will let the lender immediately identify any title problems and defaults (e.g., mechanic's liens, prohibited encumbrances, missing assignments to the lender) that should be cleaned up as part of any negotiated extension. If the loan is transferred, then the buyer will ask for the same title information.

Eventually the lender will need updated title information (a "foreclosure search") to identify exactly who the lender must name as a defendant, or notify, in any foreclosure action under the lender's mortgage.

When a lender first deals with a defaulted loan, though, the lender will usually want to obtain a complete title report rather than a more limited foreclosure sale search or "trustee's sale guaranty." The report should include a full search of violations, real estate taxes, judgments, etc.

A lender should not only obtain a current title report, but also regular updates of that title report as the default, workout, and enforcement process goes forward. In a perfect world, one could tell the title insurance company to automatically provide an updated search every month (or on some other regular schedule), but title companies cannot always do this. Therefore, either the lender or its counsel will need to remember to order an update regularly.

As part of the title search, or independently, the lender or its counsel should obtain an updated search for UCC filings, both to check the lender's filings and to see whether anyone else has filed competing financing statements. If the search reveals any gaps or glitches in the lender's filings, this is the time to try to correct them.

Qualification to Do Business

The lender should confirm that it is properly qualified to do business in all states where such qualification may be necessary in order to start a foreclosure. Typically failure to qualify means that one cannot commence an action in the particular state's courts, but this is readily remedied. If a problem exists, the lender should identify and fix it now before the need arises. Problems with "qualification to do business" can cause embarrassment and delays if they arise after the lender has started its foreclosure action.

Status of Mortgaged Property

Is the mortgaged property fundamentally sound? Does the problem lie with the borrower or with the mortgaged property or the marketplace? Will the prosecution of a foreclosure impair cash flow or management of the mortgaged property, or is it more resilient than that? Does the mortgaged property have more value in the borrower's hands, in the lender's hands,

or in the hands of some third-party purchaser the lender might be able to procure? These are questions the lender should consider early in structuring any strategy for dealing with a borrower default.

Monitoring; Additional Information

Any lender always wants to get as much information as possible about the mortgaged property. The time to do that is, ideally, while the borrower is still willing to cooperate. If any information about the mortgaged property is missing, or the lender wants additional information, the lender should identify it and try to obtain it early in the process. Along similar lines, the lender may want to have the mortgaged property inspected (if the lender has not recently done so), as that often turns up useful information. Beyond ordering a third-party inspection, it will often make sense for the personnel handling the loan to actually go visit the mortgaged property and look at it themselves.

Construction

If any material construction work is under way and incomplete, the lender should consider any measures it can take to assure its prompt completion. The existence of any such work may raise major issues if the loan goes into default and the lender needs to take over the mortgaged property. Even if construction work has been completed — but only recently — issues may arise from disputes with contractors. The lender may want to look further into these questions, such as by speaking with the contractors (with the borrower's consent). Are there pending disputes with contractors? Relating to what issues? Does the lender have copies of the construction contracts? If not, the lender may want to request them from the borrower. (The special issues of defaulted construction loans are otherwise beyond the scope of this chapter.)

Recent Leasing

To the extent that the borrower has recently been negotiating leases, the lender should probably make sure that the lender is completely aware of what's on the table and decide whether the lender has issues with it.

Audit

Does the lender want to conduct an audit regarding proper application of loan proceeds? Does the lender have any possible concern about how the borrower has applied income of the mortgaged property in recent years?

Escrows; Servicing Issues

Are the escrow accounts for the mortgaged property fully funded? Are there any other servicing issues that the lender may want the borrower to address? Any missing reports or documents? Missing evidence of insurance? Are real estate taxes current? What are the balances in the various reserve and escrow accounts? Do those accounts contain all the funds they are supposed to contain? Have any reserve accounts been transferred to other uses or misapplied?

Cash Management Arrangements

If the loan provides for any lockbox arrangements — either at all times or on a "springing" basis — are those arrangements in place? Do the proper accounts exist? Are the borrower's operating procedures consistent with what was expected when the loan was closed? Is the borrower using the same account that was originally expected to be used? Where's the money? All the money? Including all the reserve funds?

Miscellaneous Searches

Does the lender want to perform any background research of any kind to get a better picture of the borrower's status? Obtain a credit report? Litigation search? General background investigation? Corporate status investigation? Portfolio overview of the borrower and its principals? A little digging — sometimes even just a "Google" search online if the relevant name(s) are at all unusual — can often produce a great deal of useful information.

Other Due Diligence

Consider updating any or all of the due diligence performed for the closing. For example, the lender will usually want to obtain an updated environmental report.

Postclosing Loose Ends

If any loose ends remain from the closing or from any prior amendment of the loan documents, identify them and be ready to take care of them now if the opportunity presents itself. Should the lender have given notices to any third parties about the closing of the loan or any previous transfers of the loan? Was everything recorded that should have been recorded? Were any letters of credit reissued as necessary?

Borrower's Tax Position

If the borrower were to lose the mortgaged property tomorrow in foreclosure, would that cause the borrower to incur phantom income? In many cases, it will, and that fact will color the borrower's entire approach to the loan. Often, the borrower can mitigate its tax problems by waiting until the next tax year to lose the mortgaged property, and a lender can often help the borrower meet this goal as part of a negotiated resolution of the loan.

SPE Compliance

Far more important than any separateness covenants in the loan agreement or delivery of a substantive consolidation opinion at closing is the question of how the borrower actually administers its affairs, specifically whether the borrower has in fact been complying with any "single-purpose entity" covenants in the loan documents. If the borrower is egregiously out of compliance with those covenants, this may create some small risk of "substantive consolidation" in a bankruptcy of the borrower or one of its constituent companies. That risk is, however, nowhere near as great as one might infer from all the attention paid to the issue in some loan closings.

The lender may want to ask the borrower to deliver some evidence to confirm it is in full compliance with the "single-purpose entity" covenants. This is an area where nice reassurances from the borrower are interesting but ultimately of little value. A lender really wants to know what's actually happening in the borrower's operations. Can the lender send someone to review the borrower's books and records and actual business practices? Some loan documents provide for an "SPE monitor" who inspects regularly to confirm the borrower remains in compliance with the SPE covenants. Have such inspections been performed? What did they show?

If the lender and the borrower ultimately agree to a modification of this loan, the lender might be able to add such a provision to the loan agreement. If not, the general provisions on reporting, auditing, access, and inspection already in a typical set of loan documents may give the lender enough rights to achieve the same result.

The lender might want to ask the borrower's auditors to examine the borrower's compliance with the SPE covenants and issue an "agreed procedures report" to confirm, for example, that the borrower is not commingling funds with its affiliates (and as many other measures of SPE compliance as are reasonably possible under the circumstances). Such an analysis would be very easy for an auditor to perform in the course of regular audit functions.

Preparing for Battle: The Lender's First Steps

Beyond learning as much as possible about the loan, a lender should consider taking a number of early steps to prepare for battle with the borrower. Those include the following.

Estoppel Certificate

There is no harm, and may be some benefit, in asking the borrower to sign and deliver an estoppel certificate relating to the loan, in which the borrower confirms the status of the loan, the amount outstanding, the fact that the borrower has no claims against the lender, and similar matters.

Loan documents usually require the borrower to sign such a certificate. If the borrower refuses, the lender will be able to add one more default (though a minor one) to the lender's notice of default. If the borrower cooperates, which is unlikely but conceivable, the lender will have more information and may identify issues that the borrower plans to assert later.

Confirmation of Address

Check that the lender has the right notice address(es) for the borrower and any guarantors anyone who should receive copies of any notices under the loan documents. Has the borrower moved or replaced its counsel? Has the lender received any formal notices changing the borrower's address? Are the lender's records current? The lender may want to send a formal notice to the borrower, asking the borrower to sign and return the notice to confirm its current notice addresses. That particular confirmation notice can be sent by any reasonable means (and, if possible, in compliance with the loan documents), but whether or not the means of transmission complies with the loan documents, the notice should help prevent future issues and problems.

In the event of uncertainty, the lender should send notices to every addressee or recipient that might be appropriate under the circumstances.

Acceleration

If the loan goes into default before its scheduled maturity, the lender will usually be well advised to accelerate the loan at the earliest possible opportunity. Acceleration must be unambiguous. In many states, it requires formal notice to the borrower whether or not the loan documents require any formal notice of acceleration. Even if the loan documents expressly waive acceleration and seem to suggest that the lender can secretly accelerate, formal written notice will often be essential.

Any notice of acceleration should be prepared by counsel. Acceleration is an important first step in the enforcement process and should almost always occur at the earliest possible moment. The notice of acceleration should include a statement of the basis for acceleration and all amounts due under the loan, including interest (at the default interest rate if applicable), fees, reimbursement of protective advances, and all other items. The total loan amount can be subject to adjustment, but the notice should say so and try to specify any uncertainties in the calculation. The lender should carefully calculate the entire amount due under the loan. This

calculation should be complete and will take time. Start early. If the notice omits any of the borrower's monetary obligations, the lender may face a slightly uphill battle to add it later.

Although it is legally possible to accelerate the loan as part of the foreclosure complaint, that practice is usually inadvisable, as it may vitiate the acceleration if the complaint is withdrawn or dismissed. The complaint should instead merely repeat an acceleration that has already occurred outside the litigation papers.

Demand for Payment

If the loan is not paid when due on its maturity date, the lender should be ready to make a formal demand for payment the next morning. The scope and terms of such a demand will require some consideration but such a demand raises most of the same considerations as a notice of acceleration as discussed above.

Don't Send Interest Bills

Once the loan matures, do not send out monthly bills for just the unpaid interest, either at the regular rate or the default rate. If sent, bills should include the entire matured principal amount and interest at the default rate. If the borrower makes any regular interest payments, consult counsel before accepting them. Do this quickly. Most lenders prefer to reject such payments immediately, but this is not necessarily always required under state law, particularly if the lender makes it clear that the payment does not reinstate the loan. The outcome of this issue depends very much on state law.

Take Control of the Loan

As soon as a loan gets into trouble, it is no longer "business as usual." If a regular servicer has been routinely servicing the loan, the lender may want or need to transfer servicing to a special servicer or take back responsibility for the loan. Left to their own devices, servicers will take a number of actions (e.g., sending regular monthly statements showing only interest due on the loan) that the borrower can later use as the basis to argue a waiver by the lender. Give the borrower a notice that the lender's address has changed — either to the address of the counsel handling the foreclosure or to an address of someone within the lender's organization who is overseeing the defaulted loan. Update the servicer's records so that the servicer will not send any notices to the borrower. For example, the servicer might be asked (as a protective measure) to update the borrower's address in the servicer's records to be the same as the lender's contact person for the loan. That way, any erroneous notices the servicer sends should never get to the borrower — it should go to the lender instead — and can be managed as part of managing the loan.

The lender may also want to send a notice to the borrower, formally terminating all authority of the servicer to act for or bind the lender in any way.

Immediate Third-Party Notices

As early as possible, a lender should try to identify any third parties to whom the lender should send notices of default, or notices that may be necessary to take control of assets such as operating accounts. Those notices should go out as soon as the necessary conditions have been satisfied. They should be straightforward, simple, and unambiguous, and specifically tell the recipient what he, she, or it can and cannot do.

Similarly, consider whether the lender must notify any third parties before the lender commences foreclosure proceedings. For example, a hotel may require the lender to notify the licensor a certain period before commencing foreclosure.

The lender may also have rights to require tenants to pay their rent directly to the lender or the lender's servicer. A lender may need to send notices to trigger those rights, although typically a lender would prefer to obtain the appointment of a receiver instead of collecting the rents directly.

Enforcement Plan

Try to develop and document a written plan for enforcement of the loan documents, summarizing each of the major steps the lender intends to take, and the anticipated timing of that step.

Preworkout and Standstill Agreements

Standstill Agreement

When a loan is heading toward a maturity default, the borrower will typically propose to "freeze" everything during a "brief" extension of the maturity date. The borrower will argue that the "brief" extension now being requested should not produce any substantive change in the position of the parties. The borrower will argue that the lender — perhaps as a "sign of good faith" — should simply agree to defer enforcement while the parties work hard to come to an agreement on the loan: "How can we talk while we're fighting?"

In most cases, any such "standstill" benefits the borrower but not the lender. A lender should typically continue all enforcement activities during any workout discussions, particularly where those enforcement measures require notice, opportunity to cure, or a long response period.

As a compromise measure, it may make sense to suspend certain enforcement activities — those with a short fuse — but continue other activities with a longer fuse. In California, for example, the lender might still record a notice of default, which starts a 90-day waiting period, but agree not to record a notice of sale, which starts a much shorter period. With a compromise like this, the lender may give the borrower only a relatively slight concession, possibly in exchange for meaningful improvements in the lender's position.

Preworkout Agreement

Before a lender initiates any discussions with a borrower about an extension or modification of the loan, the parties should enter into a preworkout agreement. Lender's counsel can quickly provide such an agreement when needed, or the lender may have a standard form that the lender has used before. (For an example of a comprehensive preworkout agreement, see Appendix 18A.) Without such an agreement, anything the lender does or says in workout negotiations can and will be used against the lender in any subsequent litigation.

For example, any statement of the business deal the lender would like to reach will be used as evidence of the evil motivations that drove the lender's refusal to "work with" (i.e., capitulate to) the borrower.

In negotiating a preworkout agreement, any lender will be tempted to try to obtain at least some concessions of the types suggested above — starting with the borrower's acknowledgment that the loan is not in default and the borrower has no defenses. Whether the lender will succeed in this effort depends entirely on how badly the borrower needs the "breathing space" that a preworkout agreement can offer. In most cases, the borrower's counsel will strongly counsel the borrower, at the "preworkout" stage, not to do anything to improve the lender's position. A lender's efforts to seek such improvements may create an atmosphere of "ill will" (perhaps also known as seriousness) at the outset of these discussions.

Because of the uncertainties of any workout negotiations, if the lender anticipates incurring significant legal fees, the lender may wish to require the borrower to deposit sums to cover those fees as the price of having the first meeting. Many borrowers will, of course, categorically refuse to make any such deposit.

Basic Terms of Any Preworkout Agreement

A preworkout agreement — a sample of which appears in Appendix 18A — will typically cover at least the following bases:

- Identification of the loan documents. Ideally, the borrower will also acknowledge that the loan documents have not been amended or waived, but this can quickly bring discussions into incendiary territory.

- A statement that the parties will be talking, but nothing they say or write can be used against them or is admissible in court for any purpose, and nothing will be deemed binding until approved and signed by both parties.
- An acknowledgment that the workout discussions are settlement discussions and are not admissible as evidence in any way. Some recent case law has concluded that "admissions of fact" made in settlement discussions may be admissible as evidence. The lender may (and may not) want the preworkout agreement to expressly protect "admissions of fact."
- Perhaps an agreement that all discussions will take place only between designated representatives of each party, and neither party will communicate with any other representative of the other party.
- The borrower's acknowledgment that the lender is free to discontinue these discussions at any time, and therefore the borrower should never assume that the discussions will bear fruit. To the contrary, the borrower should continue its efforts to refinance or sell the mortgaged property.
- Other terms and conditions based on the experience of the particular counsel and parties and the nuances of the particular loan.

Lender Rights and Remedies

Foreclosure

A lender should always be able to foreclose if a borrower fails to pay a mortgage loan when due. In most states, the foreclosure can take one of two forms: (1) a nonjudicial "trustee's sale," which is relatively fast and simple but may raise issues about enforcement of guaranties and availability of deficiency judgments, or (2) a "judicial foreclosure," which is slower but more likely to preserve other rights and remedies if handled correctly (although this option often carries with it a "right of redemption" after sale).

Either way, a foreclosure ultimately forces an auction sale of the mortgaged property, with the proceeds being applied first to repay the loan. The procedures and timing of foreclosure vary widely from state to state.

As an example of the issues that arise in this area, the following are some general rules that apply under California law when a lender holds California deeds of trust as well as guaranties or mortgages in other states. This does not constitute a complete description of applicable California law, especially as it might apply to any particular loan. A lender's counsel should analyze these issues in detail for any state(s) where the mortgaged property is located, before the lender takes any action at all to enforce its rights and remedies. As an example, if the lender is considering "setting off" the borrower's bank accounts as a measure to enforce the loan, the lender should not even take that step without considering state foreclosure law. In California, merely exercising a right of "setoff" can destroy the lender's right to enforce its deed of trust.

The following is a thumbnail summary of some elements of California antideficiency law, as it might apply to a typical multistate loan:

- *"One Form of Action."* California Civil Procedure Code (CCP) Section 726 states: "There can be but one form of action for the recovery of any debt, or the enforcement of any right secured by mortgage upon real property, which action must be in accordance with this chapter." This means a lender can pursue only one type of action against a borrower — either foreclosure or personal lawsuit. Pursuit of one precludes pursuit of the other.
- *"Security First."* Under CCP Section 726, a lender must first try to recover as much as it can from the mortgaged property before suing on the debt.
- *Out of State Collateral, Generally.* When the borrower is in California but the mortgaged property is not, Section 726 does not apply. This means a lender may foreclose on collateral outside of California and Section 726 will not prevent the lender from pursuing another remedy, such as a deficiency judgment, in California against the same borrower. (But see the discussion below.) Also, the lender can sue on the note first — without first foreclosing on the out-of-state collateral.
- *No Deficiency Judgments.* Under California Civil Procedure Code Section 580d, if a lender enforces its deed of trust against the mortgaged property, then the lender may not (in general) obtain a deficiency judgment against the borrower in California. (A "deficiency judgment" means a judgment against the borrower or a guarantor for whatever part of the loan the lender was not able to recover through its foreclosure sale.) When the borrower is in California but the mortgaged property is not, this rule still applies, according to the one California court that considered the issue. Under this case, if the lender forecloses on out-of-state collateral, the lender will not be able to obtain a deficiency judgment in California.
- *Out of State Judgments.* Notwithstanding Section 580d, if a lender sues a borrower outside of California and obtains a judgment (including a deficiency judgment), that judgment should be enforceable in California.
- *Guarantors.* California's antideficiency rules do not protect guarantors, assuming the guaranty contains all the typical waivers normally obtained in California.

The preceding discussion is intended not so much as an authoritative explanation of California law — which it is not — but instead to demonstrate the kinds of issues and surprises that can arise in this area. Those issues and surprises underscore the importance of consulting counsel in the state where the mortgaged property is located before taking any steps at all to enforce the loan.

Timing. When a lender initiates any form of foreclosure, the lender should understand how long the process is likely to take. Sometimes a state allows more than one type of foreclosure, each with its own timeline. For example, a lender holding a California deed of trust can usually proceed with a nonjudicial "trustee's sale," a process that involves a series of waiting periods

aggregating in the very best case about four months: 111 days for the nonjudicial foreclosure process itself, followed by 20 days to clear federal tax liens. Just before the lender finally holds the foreclosure sale, the borrower will typically file a voluntary bankruptcy petition. The implications of such a filing are discussed below.

By commencing a nonjudicial foreclosure, a lender begins to place pressure on the borrower and may accelerate the inevitable bankruptcy — which may be a good thing rather than a bad thing, as more fully discussed below. Yet the mere commencement of a nonjudicial process does not itself generally cause problems or issues under antideficiency law. The problems arose only at the moment the mortgaged property is auctioned off nonjudicially to the highest bidder — the moment the hammer falls at the sale. Therefore, in California a lender can usually be aggressive about starting the nonjudicial foreclosure process as early as possible, but should be judicious about actually holding the foreclosure sale itself.

Appointment of a Receiver. Once a lender starts a foreclosure action, the lender can usually have a receiver appointed to capture the rental income of the mortgaged property. The receiver will take possession of the mortgaged property as an officer of the court, and should collect rent, pay operating expenses, make payments on the loan, and (in theory) protect the mortgaged property from whatever deterioration might result if the borrower stayed in control.

The appointment of a receiver will often trigger an immediate bankruptcy filing, which raises some issues discussed below. In most cases, a lender will want to appoint a receiver or otherwise gain control of the rental income of the mortgaged property as soon as possible, although this may depend on the lender's assessment of the borrower's competence and reliability in handling rental income. (For example, a public company will behave differently from an individual who owns a small apartment house.)

Because a receiver will take over the borrower's operation of the mortgaged property, the responsibilities of a receiver can be complex and intricate, as are the legal requirements that govern the process. For example, the receiver may be required to post a bond, for which someone — typically the lender — will need to pay.

Rent Collection Measures. Depending on the terms of any tenant estoppel certificates or subordination, nondisturbance, and attornment agreements with tenants, the lender may be able to send notices to tenants, instructing them to pay their rent directly to the lender. Although this remedy may theoretically be available (where provided for), a mortgagee would typically prefer to have a receiver appointed to collect the rent, to avoid the risk that the mortgagee might be deemed a "mortgagee-in-possession" and to avoid having to consider any California one-form-of-action implications. The practicalities of rent collection depend in part on the number and size of tenants in the mortgaged property.

Application of Cash. The loan documents may give the lender control over various bank accounts, such as a lockbox account, escrow accounts, and reserve accounts. The loan documents may also say the lender can take the money in those accounts and apply it to the loan. Before doing so, though, the lender should ask counsel to consider whether the use of those

funds in that way would create legal exposure. First, in some states (e.g., California), the application of such funds might impair the lender's ability to hold a foreclosure sale. Second, in many states, governing law (the UCC) may establish procedures that the lender must follow in order to apply collateral against the loan without holding a public auction sale of the mortgaged property. The lender should comply with those procedures.

Foreclosure Process and Sale. For any complex commercial loan, the foreclosure process, whether judicial or nonjudicial, will raise a host of issues all along the way. These issues will vary from state to state and based on the specific words of the specific loan documents. Although many of these issues are "legal" in nature, they will surprisingly often require "business" type judgments by the lender. As just one example, the lender must act strategically in deciding how much to bid at the foreclosure sale. The decision will depend in part on tax issues; willingness to hold the mortgaged property (Does it have environmental problems? Can the lender manage it?); availability of guaranties and other collateral; and as in so many other contexts, the value of the mortgaged property. Usually, a lender will not want to bid more than the value of the mortgaged property (conservatively measured) and may often be willing to stop bidding well below that point, even if the loan balance is higher (as it usually will be in these cases). And if the lender determines it does not want to own the mortgaged property at all — but instead wishes to pursue other rights and remedies — the lender and its counsel will need to assure that no steps taken in the foreclosure action would preclude the lender from pursuing those other rights and remedies. Entry of a judgment of foreclosure may limit or bar other remedies in some states.

Bankruptcy

Although state law governs the foreclosure process, the resolution of any troubled loan will very often be determined under federal law: the bankruptcy code. A borrower facing foreclosure will often voluntarily commence federal bankruptcy proceedings just before the foreclosure sale. These federal proceedings will instantly "freeze" the state court foreclosure. The bankruptcy process supposedly preserves the "going concern" value of a business and its contributions to the community, such as jobs, by preventing the company's creditors from ripping apart the company piece by piece. Toward that end, bankruptcy law lets borrowers modify their loan obligations under certain circumstances and take other steps to "reorganize," even over the objections of some of their creditors. (The rationale for bankruptcy reorganization makes relatively little sense in the context of typical commercial real estate investments, but the law still applies to many of them.)

Lenders often fear the prospect of a bankruptcy filing. They think of it as the final arrow in the defaulted borrower's quiver and a weapon that often produces particularly bad results for lenders. While there is some truth to this view, a lender may also conclude that a troubled borrower will sooner or later end up in bankruptcy anyway, and the lender may prefer to see it happen sooner rather than later, to prevent further deterioration and delay.

On the other hand, if the lender expects that it will eventually agree to some form of "workout" that the borrower will find palatable, the parties will save time, trouble, and agony if they can reach that agreement consensually before the borrower files bankruptcy and, ideally, before the lender even commences foreclosure.

Once a borrower does file, the bankruptcy process supposedly considers the interests of all parties concerned, including secured and unsecured creditors, by giving each party certain rights it did not otherwise have.

Bankruptcy can produce the following benefits for a lender:

- The lender should have some ability to participate in controlling the cash flow of the mortgaged property.
- Depending on the state of its docket, the bankruptcy court may participate actively in the borrower's business decisions and operations — a discussion in which creditors will have more of a voice than they might outside bankruptcy, yet with no fear whatsoever of "lender liability" claims.
- If the borrower has other creditors, bankruptcy may give the borrower and the lender stronger leverage to deal with them if they are not otherwise inclined to cooperate. If those other creditors are already trying to enforce liens or judgments against the borrower, a bankruptcy filing can stop that process.
- In appropriate cases, the creditors may be able to have a trustee appointed, although this is rare.
- Most bankruptcies are resolved by a negotiated plan of reorganization, which can include "deeds in escrow" if the borrower defaults after plan confirmation. Those "deeds in escrow" should be enforceable, even though they would typically not be enforceable if entered into as a "private" transaction outside bankruptcy. The lender may also be able to provide for other unconventional rights and remedies, and obtain reasonable comfort that those rights and remedies will be enforceable.
- If the borrower cannot satisfy the federal standards to "reorganize," and the court realizes and accepts this fact, then bankruptcy may be quicker than foreclosure to resolve the loan.
- In a state that imposes transfer taxes on foreclosure deeds, such as New York, the transfer of the mortgaged property to the lender through a plan of reorganization (and sometimes even other forms of transfer through bankruptcy) will eliminate some or all of those taxes, which can be substantial.
- The sooner the filing occurs, the sooner it can be resolved.
- In some parts of the country, federal bankruptcy judges are regarded as "better" (more practical, less patient, more qualified, better trained) than state court judges.

- If the borrower and the lender negotiate a workout through the bankruptcy process (which happens in almost all cases), the workout will be blessed by the bankruptcy court and not subject to future invalidation in a subsequent bankruptcy of the borrower.
- If the lender can force or persuade the borrower to sell the mortgaged property through the bankruptcy — either to the lender or to a third party — then the blessing of the bankruptcy court removes significant issues from the potential transfer of the mortgaged property, and may attract third-party bidders. First, the court's blessing means that the transfer cannot possibly be set aside in any subsequent bankruptcy filing by the borrower, a risk that would otherwise exist with any transfer of the mortgaged property. (This risk is, however, typically very small and more theoretical than real.) Second, the bankruptcy process can produce unambiguously clear title to the mortgaged property by decreeing the termination of many title exceptions and complications that might otherwise create issues. For example, if the mortgaged property is subject to an undesirable management agreement that might arguably survive foreclosure, the bankruptcy process may be able to remove that management agreement.

The benefits of the bankruptcy process, as described above, can be substantial, saving the lender both time and money in dealing with a defaulted loan. Bankruptcy is, of course, not a nirvana for lenders. Bankruptcy does give borrowers significant weapons they would not otherwise have, but if the loan is heading toward bankruptcy in any event, there is no reason a lender should hesitate to hasten that process.

Because of the possible benefits of a bankruptcy, even if the parties negotiate a consensual workout, they may find it makes sense to consummate the workout through a prepackaged bankruptcy plan of reorganization. For example, if the "workout" consists of the borrower's transferring the mortgaged property to the lender, if they accomplish this through a plan of reorganization, some of the bankruptcy benefits listed above may simplify and reduce the cost of the workouts. In such circumstances, the parties may prepare a "prepackaged" plan of reorganization, which would then be filed and approved in a relatively short time.

As a final thought on bankruptcy, to some degree, Congress and the courts may increasingly recognize that single-asset real estate borrowers are not true operating businesses of the type that bankruptcy was intended to protect. Hence, the appeal of bankruptcy as a real estate borrower's last refuge is diminishing. It can reasonably be expected to diminish further over time.

Negotiated Extension/Workout

When a loan matures and the borrower cannot pay it — or if the lender accelerates the loan before maturity because of some other default — the borrower and lender will very often negotiate a brief extension of the loan as a short-term resolution of the problem (or postponement of the inevitable).

Such an arrangement can give a borrower some additional time to try to resolve its problems, and can spare both parties (at least in the short term) the expense and distraction of litigation. And it can allow the lender both to improve its security and economic position and to correct any defects or flaws that might exist in its loan documents. In the case of a maturity default, if the lender believes the borrower will not pay on time anyway — i.e., the borrower will defer repayment of the loan whether or not the lender agrees to it — then arguably the lender should try to get something for the extension, beyond default interest and attorneys' fees.

Price of Extension: Deal Improvements. As the price of any extension of a loan, a lender might consider asking for some or all of the following improvements in the terms and structure of the loan. These measures overlap some of the longer-term "workout" measures discussed at greater length below.

- Extension fee
- Additional reporting requirements
- Immediate cash controls (lockbox) for part or all of the mortgaged property
- One-time principal reduction payment
- Cash deposit to cover future enforcement costs
- Equity or equity equivalents (warrants, shared appreciation, options, etc.)
- Bifurcation of the loan into two notes to improve the lender's internal accounting treatment
- Other changes driven by internal reporting concerns, such as the standards that must be met for a loan to be deemed "performing"
- Interest and other reserves
- Reimbursement of the lender's costs already incurred
- Deletion of any undesirable deal terms, such as transfer restrictions or confidentiality requirements that limit the lender
- Other measures, depending on the particular circumstances of any particular loan

Price of Extension: Correction of Flaws. To the extent that the lender has identified flaws and defects in its security package or documentation, the lender may want to insist that the borrower correct them at the time of extension. This requires a review of the loan documents (as suggested above). If the lender completed that review early in the process, the lender will already know of any gaps that require repair. More generally, any set of loan documents can usually be improved in one way or another.

Based on further analysis of the enforcement process, would it help to create additional "separate notes" tied to particular mortgages? Do the loan documents fully provide for all necessary or appropriate lender remedies? Do the documents require sufficient financial and other reports? Do they give the borrower more flexibility than the lender might prefer in some ways,

such as regarding transfers or leasing activities? Has the lender's internal review and administration of the loan identified any provisions that the lender wishes were in the loan documents but are not? Any provisions that are in the loan documents but the lender wishes were not?

Price of Extension: Practical Improvement of Lender's Position. In addition to deal improvements and correction of flaws, a lender that negotiates a "workout" or extension of a loan may ask for measures such as the following to simplify future enforcement efforts:

- If the lender has already served a foreclosure complaint, the lender may want the borrower to admit that such service was valid. If the lender has not yet served a complaint, the lender may want to serve the complaint quickly (with an admission of service) but hold the lawsuit in abeyance during the workout. This can save time if the discussions break down or the loan goes into default again.
- The lender may want the borrower to deliver any missing property-related documents, such as tardy financial reports and copies of all leases in existence.
- The lender might request complete financial statements of all guarantors, with specific lists of properties and ownership structures to facilitate future enforcement of a judgment.
- A borrower's waiver of antideficiency and one-form-of-action protections may in some cases actually be enforceable if delivered in the context of a "workout," although this very much depends on the circumstances and governing law.
- The lender may want the borrower to deliver a waiver, estoppel certificate, and release regarding potential defenses and offsets, possible lender liability claims and theories, and the outstanding balance of the loan.
- The lender may ask the borrower for representations, warranties, and acknowledgments designed to respond to (and perhaps prevent) typical borrower theories in foreclosure actions and bankruptcies. For example, the borrower might acknowledge the value of the mortgaged property; the fact that the borrower has no equity; and similar matters. Whether a court will honor any such acknowledgments represents another discussion, but they should cause no harm (although this depends very much on the particular circumstances of the particular loan).
- If the loan documents or the mortgaged property raise specific issues, the lender may want the borrower to resolve those issues as part of the workout documentation.
- The lender may want the borrower to reaffirm the lender's security interests and correct any gaps or glitches that have been discovered to date.
- The lender might be able to have the borrower waive the "automatic stay" that would prevent the lender from prosecuting a foreclosure action after the borrower files bankruptcy. The bankruptcy courts have been known to enforce such waivers, particularly if the borrower signs them in the context of a workout, although not always.

- Similarly, the borrower might waive the 120-day period during which the bankruptcy code would give the borrower, as debtor, the exclusive right to propose a plan of reorganization under Chapter 11. Again, such a waiver might be enforceable.
- The lender might ask the borrower to agree to a "stipulated judgment of foreclosure," in which the borrower consents to a foreclosure sale. That judgment would be held in abeyance as long as the borrower performed under the workout.
- The lender may take other measures as well, depending on the particular circumstances of the loan.

The preceding laundry list of "workout" measures demonstrates the range of possible steps that a lender might want to take to improve its position if the loan goes into default again. To know what to request, though, the lender must understand the loan documents and all the surrounding facts. That underscores the importance of the preliminary due diligence measures suggested above.

Reclosing of Original Loan

In addition to the measures suggested above, a lender may also want to consider reclosing parts of the original loan, such as by requiring updates to tenant estoppel certificates or other reconfirmations of facts about the mortgaged property. In most cases, a lender will decide that the money is already out the door and the time (and budget) do not permit these measures, but the lender may nevertheless want to consider them. If, for example, the lender is particularly concerned about one specific tenant, the lender may want to request an estoppel certificate from that particular tenant.

Business Context

Whether the lender can reasonably expect to obtain any of the foregoing measures depends completely on the larger business context and the lender's overall negotiating leverage. Also, some of these measures may create risks and issues of their own, which the lender's counsel can assess if and when they become relevant.

Longer Term Workout

So far, this chapter has, at least in part, considered aggressive and confrontational actions a lender can take when a loan goes into default. If the lender retains confidence in the borrower, though, it is more common for the parties to try to work out an interim or longer-term solution to the loan, short of foreclosure, litigation, and bankruptcy. Many of these workouts ultimately turn out reasonably well, without the time, expense, effort, animosity, and bad publicity that can follow from a borrower-lender battle.

The following menu summarizes many common components of any longer-term workout of a loan. This list is not mutually exclusive with the discussions above. A lender will want to take many of the actions suggested above as a prelude to (or as part of) agreeing to some of the longer term measures suggested here.

Equity Pledges. The lender could obtain pledges of the equity interests in the borrower (partnership interests, membership interests, etc.) to give the lender a second path for foreclosure. Although equity pledges are often overrated as a form of security, they do no harm and could give a lender more leverage, particularly if the lender obtain pledges of 100% of the equity. The lender might also want to think about the practicalities of exercising remedies under such an equity pledge and actually taking control of the borrower's operations after doing so.

For example, the lender might want the original signed leases, complete bookkeeping histories for each tenant, keys, copies or originals of service contracts and permits, and other documents and items that will in practice be necessary to control the mortgaged property if the lender ever takes over. The lender might want to think about some of these considerations even if the lender does not take an equity pledge.

Adjustment of Terms. The lender might want to build into the loan documents an automatic adjustment of terms at certain stages. For example, the interest rate might automatically increase if the borrower fails to pay the loan on maturity, or even at some earlier point if the borrower falls out of compliance with a debt service coverage or loan-to-value test. The lender might be able to negotiate other consequences for failing either such test, and might even be able to increase the interest rate immediately as of the closing of the workout.

If the loan goes into default again, the lender would certainly have the option of foreclosing and enforcing all its other remedies, so one might ask why the lender should bother with lesser measures. As a practical matter, though, the lender might appreciate the flexibility.

Built-In Workout. Along similar lines, in the early nineties, when all real estate lenders and their counsel handled a huge volume of mortgage workouts, many of those workouts boiled down to one simple transaction: a so-called "cash flow mortgage." Under this transaction, the parties would often modify the lender's mortgage to say that the lender takes all the cash; uses it pay as much interest on the loan as can be paid; accrues the unpaid interest; extends the maturity date; waits; controls the mortgaged property; and may take a piece of the borrower's future profits if the market turns around. These "hope certificates" often turned out to be quite valuable in the medium term. Until then, they gave a lender almost everything the lender might achieve through a foreclosure, without the marketplace stigma, dislocation, and transaction costs of a change of ownership.

As part of a negotiated workout of any loan, a lender might want to build such a transaction into the loan documents. The lender might adjust the rate and term of the loan as suggested above, but also give the lender a percentage of the upside of the mortgaged property. Typically this percentage would be fixed and would not exceed 50%. As an alternative, the percentage could start at, say, 10% and rise to a much higher level over time. Although such a transaction is economically

a first cousin to a deed in escrow, it is probably more enforceable and less work to document. The "gradually vanishing equity" option would, however, probably raise more enforceability issues than a straight equity participation at, say, a simple 50%.

Planning Ahead for a Deed-in-Lieu. Another common "workout" from the early nineties consisted of a deed-in-lieu of foreclosure, often deferred to the borrower's next tax year so the borrower's principals could reduce and defer adverse tax consequences. Even for a borrower willing to hand over the keys, though, two barriers often stood in the way of these transactions: transfer taxes and minority investors in the borrower whose consent was needed but withheld. A lender should consider these issues as part of its strategizing for a possible future default.

If state law imposes transfer taxes on a deed-in-lieu of foreclosure (or a deed given through a friendly foreclosure), the lender might set up a reserve now to pay them. Even if the documents require the borrower to pay such taxes, such a covenant is meaningless in a nonrecourse loan unless the lender obtains a reserve or personal guaranty.

If the borrower's organizational documents would require limited partners' (or other passive investors') approval for such a deed, the lender could insist that the borrower obtain that approval at the time of the workout, so that the transaction is ready to go when the need arises. (Of course, that creates leverage for the minority investors, but they will eventually have the same leverage later.) Although the documents for a simple deed-in-lieu of foreclosure are rarely difficult, the lender could also prepare, negotiate, and finalize any necessary documents at the time of the workout. This might help save time and simplify the process.

As a variation, the borrower might transfer a 99% interest in the mortgaged property to the lender and retain a 1% interest. Such measures can sometimes allow the borrower to avoid adverse tax consequences. At some point, though, the lender will need to be able to sell the entire property to a third party.

Deed in Escrow. The lender may wish to ask borrower to sign and deliver in escrow a deed of the mortgaged property to the lender (or, more likely, in blank), together with all necessary transfer tax returns and related documents. In general, a "deed in escrow" is usually considered to be fairly worthless in most states, unless backed by a prepackaged bankruptcy plan or guaranties of the loan by the borrower's principals, which guaranties would "spring" into effectiveness only if the borrower ever tried to interfere with the deed in escrow.

On the other hand, occasional cases do validate deeds in escrow, although it depends very much on the facts. A deed in escrow does no harm except to run up legal fees and, in most cases make the lender look naïve.

Friendly Foreclosure. As a variation on the prepackaged bankruptcy suggested above, the lender could require the commencement of a "friendly foreclosure" as part of the workout, with a stipulated judgment to be entered in the foreclosure action as quickly as possible. The borrower might not be willing to go along with such a measure, though, because of image issues. Moreover, any such plan still leaves the lender with the risk of a subsequent bankruptcy filing.

Although one can never be sure that the courts would honor a "friendly foreclosure," it would at least save the lender some early procedural time.

Delayed Friendly Foreclosure. As another variation, the borrower and lender might agree that within a certain time period, the parties will direct their counsel to prepare all necessary papers for a friendly foreclosure (including a stipulated judgment of foreclosure), with the lender being authorized to file those papers immediately if specified events occur. If the foreclosure documents were not finished by a specified date, this would constitute an event of default. Such a plan would prevent bad publicity for the borrower but perhaps allow the lender to get a jump on the foreclosure if necessary later. A future "friendly foreclosure" raises the same concerns as a present "friendly foreclosure," though.

Simplification of Future Foreclosure. Along similar lines, it may make sense to ask the borrower to sign a "confession of judgment" — a document in which the borrower consents to the entry of a judgment against its assets — or a stipulated judgment of foreclosure. Either could simplify and speed up future enforcement, although both may suffer from the same infirmities as deeds in escrow and any other measures that seek to deny a borrower its day in court.

Deed-in-Lieu of Foreclosure. If the borrower has no equity and is willing to "give the lender the keys," the parties may enter into a "deed-in-lieu of foreclosure" transaction. This transaction can require minimal documentation — just a deed and very little more. Borrowers and lenders do, however, often prefer to supplement those minimal documents with a formal "deed-in-lieu of foreclosure" agreement. For an example of such an agreement, see Appendix 18C.

Partnership. The lender may want to ask some questions to find out whether the borrower's partnership agreement (or other organizational document) has been amended and whether there has been any other change of ownership. This could be addressed, at a minimum, through a representation and warranty in any workout documents.

If the lender knows there may be acrimony within the borrower (which is common when a project starts to run into trouble), and hence possible future litigation, the lender may want to figure out who is likely to sue, and ask the likely plaintiffs to sign a separate estoppel certificate acknowledging that whatever their claims may be, they have no claims against the lender. Such a request would, of course, give the plaintiffs leverage against the other partners today. If the documents do not already provide for it, the lender may want to have the borrower indemnify the lender against claims arising from interpartner disputes. (Such an indemnity is relatively meaningless, however, if it is nonrecourse.)

Change of Management. The loan documents may allow the lender to terminate the existing management arrangements for the mortgaged property, and require the borrower to hire a new manager in certain cases. As part of today's transaction, the lender may want to lower the threshold for replacement of the manager or perhaps require the borrower to replace the manager today, if the lender thinks this might help the project.

Budgets. Does the lender want to require updated budgets (capital and operating) in conjunction with the closing of any workout? The lender will need a current operating budget for a lockbox (if the lender establishes one) in any event. What about updated business plans?

Insurance Coverage. Does the lender want to revisit the insurance requirements of the loan documents, and beef them up as necessary?

Lockbox. The lender may want to initiate a lockbox arrangement for the mortgaged property, if a lockbox is not already in place. Most lockbox documentation is far more complicated and extensive than it needs to be and, hence, creates more negotiations and delay than necessary. A lender can, if it wishes, instead use very simple lockbox documentation. A lockbox can, for example, be implemented through a three-page exhibit to a workout agreement. An example appears in Appendix 18B.

Lockbox — Extra Teeth. In addition to establishing the lockbox and sending notices to tenants directing them to pay rent into the lockbox, a lender can take one more step, although not standard. The lender could require at least the major tenants to countersign and acknowledge receipt of the lender's rent payment direction notices, and acknowledge that they will pay rent only to the lockbox. This could eliminate some possible future uncertainty and issues, and tie up one possible loose end.

Security Deposits. If the mortgaged property has substantial security deposits, the lender may wish to take control of them (which would be consistent with having a lockbox). The same goes for any prepaid rent or any other sums that the tenants may have deposited with the borrower.

Partner Loans. To the extent that the loan agreement allows the borrower to obtain partner loans, the lender may wish to tighten the conditions for such loans, for example by adding a requirement for an intercreditor and subordination agreement satisfactory to the lender and that the lender approve all documentation regarding these loans. The lender should first find out whether such loans exist and their status, and obtain copies of any existing documentation.

Additional Security. Does the borrower or its affiliates have any assets that have done better than this one, and on which the lender could take a second mortgage or an equity pledge — or that the lender could potentially refinance and then take a second lien? The concept of giving the lender additional security may be less objectionable to the borrower than the concept of investing more cash in the deal, although functionally the two concepts are about the same. But the concept of providing additional security — or as an alternative some form of additional credit enhancement — might sometimes work.

Address. The lender should have the borrower reconfirm its correct mailing (and service of process) address. This is probably not necessary, but it can't hurt and might help.

Nonrecourse. The single best improvement to any set of loan documents would be to obtain some form of "warm body" guarantee to back up the "nonrecourse carveouts," if such a "warm body" is not already in place. And if the existing "nonrecourse carveouts" are less

extensive than the current standard, the lender may want to seek to expand them. Whether any of that is possible depends on the particular circumstances of any loan.

Other Changes. More generally, the lender should reconsider whether to try to change other business terms of the loan as part of the workout. How has the lending market changed since the original closing? What structural elements are common today in mortgage loans that might not have been common at the time of the original closing?

Transfer of Loan

Sale, transfer, or participation of the loan may be an attractive strategy, depending on the language of the loan documents, the level of interest from others in the market, and the lender's willingness to accept a discount. To the extent that the loan "has issues," though, the lender may find that those "issues" deter potential buyers to the extent that the lender would probably regard any bids for the loan as being entirely unacceptable. If that is the case, then the lender would probably be well advised to wait until the "issues" have been resolved, limited, or better defined before trying to interest other parties in the loan. Until then, any efforts to sell the loan may amount to a waste of time and a distraction.

Unless the loan documents prohibit the lender from undertaking any of these transactions, it is very unlikely that a court would interfere, even if the lender wanted to sell the loan to a direct competitor of the borrower.

Loan Sale Process. For any substantial loan, the loan sale process is very much a "process," because the purchaser will typically want to perform at least some due diligence; the parties will need to negotiate a loan sale agreement (although these have become quite standard); and the closing documentation may be reasonably extensive.

To the extent that the lender anticipates a prompt sale of the loan, the lender may want to take steps as soon as possible (if the lender has not already done so) to simplify and streamline the sale process, such as by developing due diligence materials and a simple form of contract. Of course, such measures cost money and may ultimately be unnecessary. The lender may find it has previously prepared the necessary transfer documents for this loan. For example, if the lender has already hypothecated this loan on a mortgage warehouse line, then transfer documents may already exist. In some cases, a lender might already have prepared transfer documents to have them ready for a future transfer of the loan, just because of the high likelihood that any loan will eventually be transferred.

Confidentiality. Any loan marketing program should consider any requirements of the loan document relating to preservation of confidentiality. Even if the loan documents do not restrict the disclosure of information and do not require the lender to obtain confidentiality agreements from potential assignees or participants, a lender should probably do so anyway, because such agreements are customary and expected by all parties.

In one recent case, a lender wanted to sell a defaulted loan to a competitor of the borrower. The lender gave the prospective purchaser competitive information about the borrower. The loan documents said nothing about confidentiality. The borrower sued the lender for this disclosure. But the court held that the borrower had no right to prevent (or to make a claim against the lender as the result of) the release of such information. Absent particular provisions in the loan documents, the same outcome seems likely for any other loan. Of course, any lender would prefer not to face the potential issue at all.

Transfer to Lender Affiliate. The lender may wish to transfer the loan to an affiliate, perhaps a single-purpose entity, before commencing any enforcement activities that would produce a transfer of title. Lenders often prefer not to take title in their own name, for most of the same reasons that any investor in real estate prefers to use a separate entity for each property. These reasons include avoidance of environmental liability; avoidance of tort liability (routine "slip and fall" claims, etc.); simplification of tax structuring and future transfers; possible publicity prevention; ability to abandon a disastrous investment; and so on.

If the lender anticipates transferring the loan for this purpose, it can be done at any time until the bidding begins at the foreclosure sale (or potentially even later, although some new issues would need to be considered). To prevent last-minute problems, though, the lender may want to accomplish the transfer earlier rather than later. That way, the lender and its counsel can identify any issues or problems arising from the transfer and resolve them in a leisurely manner. For example, many types of lenders cannot quickly form new subsidiaries. The process may take awhile and require some approvals. In such cases, the lender might find it makes more sense to use a previously formed subsidiary that is not otherwise very active. All of this may take some time to figure out and resolve.

If there is one general principle that runs through this entire chapter, it is the principle that a lender holding a troubled loan should think ahead and figure out what it wants before issues arise. This chapter seeks to give any such lender a roadmap for that process.

Though this chapter touches on most of the major considerations that arise in a typical troubled loan, it cannot possibly cover every issue or fully cover any of the issues addressed. The principles and themes suggested in this discussion will arise again and again, but the lender must form its strategy based on the documents and history of the specific loan at issue. The lender must also take into account the specific governing legal requirements of the state where the mortgaged property is located, as well as any other relevant state. This discussion cannot possibly do all that. It therefore merely scratches the surface.