2009 Year in Review:

Your Top 10 - ToughTimesforLenders.com

In 2009 we experienced a historic recession, with an unemployment rate of +10%, decreasing interest rates, tightening credit limits, increasing bankruptcies and shrinking investment spending. These are truly tough times for our nation's economy and the financial services industry. To further our uncertainty, economic forecasters continue to disagree on when we can expect to see "real" signs of recovery in the national economy and for the credit markets.

As a result, issues affecting commercial lending markets during 2009 generated headline news and produced important discussion topics for readers of Winstead's legal blog, "Tough Times for Lenders." In fact, due to the intense interest in commercial lending, our readership increased by 370% after launching the blog in September 2008, with 23,247 unique visitors.

The following articles represent the "top 10" most widely read postings from "Tough Times for Lenders." We hope these articles continue to produce problem-solving discussions and knowledge sharing for our community of readers.

We thank all our readers for their continued support of "Tough Times for Lenders," and we look forward to publishing more helpful news and resourceful information on issues affecting the financial services industry. We also look forward to the day when we can have a "Good Times for Lenders" legal blog (*We're hopeful—we've already reserved the domain name)*.

The Top 10:

Also:

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#1 New Federal Foreclosure Law Gives Residential Tenants 90 Days to Vacate

AUGUST 11, 2009

In May 2009, President Barack Obama signed a new law called the "Protecting Tenants at Foreclosure Act of 2009," the provisions of which were part of a much longer 72-page law known as the, "Helping Families Save Their Homes Act of 2009."

One part of this new federal law causes an important change in Texas local law on foreclosures and the rights of a tenant after a foreclosure. Effective immediately (i.e. for foreclosures occurring after May 20, 2009) and relating to certain "federally related mortgage loans" and any loans on dwelling or residential real property, the purchaser at a foreclosure sale is required to provide a bona fide tenant at least 90 days' notice before the tenant has to vacate. The new law is national in scope so tenants, no matter what state they live in, now have time to adjust their lives.

As a general rule, the new law requires any immediate successor-in-interest in property foreclosed upon to assume the property subject to the rights of a bona fide tenant under a bona fide lease until the end of the remaining term of the lease. There are exceptions to this general rule—such as the lease must be in existence as of the date of the notice of foreclosure, for example.

If a tenant is in possession of the property foreclosed upon without a lease or with a lease that is "terminable at will," the purchaser at foreclosure merely has to give the occupant 90 days' notice to vacate.

In all of the above instances, the foreclosing party can still evict a tenant who is not paying rent or is otherwise in default under his lease.

In Texas, if a mortgage was executed before the lease was executed, or if the lease was executed before the mortgage, and the lease contained a subordination provision making the lease subordinate and the mortgage superior in right, Texas law recognized that, after a foreclosure, such a tenant under such a lease would be a "tenant at will."

Even with the new federal legislation, it would arguably appear that, under such circumstances, and based on the tenant being a tenant at will, a successful bidder at a Texas foreclosure would not have to honor the lease for the duration of its remaining term, but could instead terminate it with a 90-day notice to vacate.

Note that even under Texas law, before this new federal legislation, if a home was purchased at a foreclosure sale under a lien superior to the tenant's lease and the tenant paid rent on time and was not otherwise in default under the tenant's lease after foreclosure, the purchaser was required to give the tenant at least 30 days written notice to vacate if the purchaser chose not to continue the lease. So, in this instance, the new federal law imposes a longer notice period in Texas.

Following a foreclosure, the new law says that if the tenant has no lease, he has to vacate within 90 days after receipt of a notice to vacate (which notice might be able to be given even before the foreclosure), or if there is a lease, a bona fide tenant can stay in possession for the remainder of the term pursuant to such tenant's lease. But if the lease is "terminable at will" under state law, or if a purchaser from the successful bidder at foreclosure will occupy the property as his primary residence, the tenant must nevertheless vacate—but such tenant is entitled to receive a 90-day notice to vacate.

There is a provision in the statute that says nothing in the statute shall affect the requirements for termination of any federal or state-subsidized tenancy or of any state or local law that provides longer time periods or other additional protections for tenants.

The new foreclosure provisions only affect tenant-occupied properties that are being foreclosed upon and have no affect on mortgagor-occupied properties.

The new legislation represents a big change to the law in Texas. Where we previously had scattered state laws, now we have one national statute. The law sunsets on December 31, 2012.

Thanks to Winstead Shareholder Vince Marino for this article, which was published in the *Houston Business Journal* on July 17, 2009.

#2 Lender Liability Returns: Sample Cases and Situations

OCTOBER 15, 2009

It has been a long, long time since claims of lender liability received any real attention. Indeed, Mike Baggett co-authored a book in the early '90s on lender liability. Mike's book was somewhat of a best seller among the tough times for lender crowd (which is tough for me to admit, since I went to Texas and Mike went to Texas A&M—and as a former "yell leader" at TAMU, Mike is an "Aggie's Aggie").

Since then, however, the topic has fallen off everyone's radar screen. The fall off has been this dramatic: the publisher of Baggett's book has NOT updated it since the initial publication, and it is out of circulation. But to give you a sense of how we see lender liability creeping back into play, below is a short list of where we're dealing with it now. If nothing else, it will equip you to watch for similar situations—and perhaps get ready.

- Defending a national banking association in a currently certified class action in the Eastern District of Texas challenging the bank's status as trustee for approximately 220 trusts. The bank is the latest successor trustee in a series of successor trustees and fiduciary substitutions and appointments dating back to the late 1980s. The class alleges defects in the trusteeship chain of title which purportedly disqualify the defendant bank from serving as trustee. The class seeks to recover all trustee fees paid to the bank and its predecessors, together with appointment of new trustees. Class certification is on appeal to the Fifth Circuit.

continued

- Currently defending a REMIC Trust Lender in a state court action alleging Special Servicer induced borrower into making property renovations by misrepresenting its intent to extend loan maturity and interfered in borrower's efforts to secure refinancing.

- Secured a judgment for a Hedge Fund that acted as lender to high-end residential subdivision developer. Developer contended lender breached promise to lend additional sums to complete subdivision and negligently advised borrower in connection with the development.

- Represented a lender against allegations by commercial developer/office building owner that lender had failed to fund a multimillion dollar construction loan.

- Representing a bank where the borrower and guarantor allege failure to fund and credits on guarantee liability in connection with California residential development.

- Represented a lender against claims that it and its president had aided and abetted borrower's securities fraud, including borrower's theft of millions of dollars belonging to securities customers.

- Defended a lender against a counterclaim that it improperly ceased funding loan. Lender had sued borrower and guarantor for misappropriating collateral in asset based funding arrangement.

- Defense of a national banking association in state court against lender liability lawsuits alleging claims for improper loan servicing and wrongful foreclosure.

- Defended a national residential mortgage lender in state court against lender liability actions for wrongful foreclosure.

- Obtained a successful jury verdict for a National Savings and Loan Association to collect debt owed by borrower on SBA loan. Borrower counterclaimed that bank had misled it about the profitability of the business to induce the loan.

- Defended a lender against a borrower's claim that the bank refused to refinance or modify construction loan and wrongful foreclosure on partially developed subdivision, including private water utility.

- Defending a national bank in Arizona against allegations that one of its workout officers conspired with one of the borrower's officers and other borrower-insiders to steal the borrower (a closely held corporation) from its owners through a negotiated private sale of the borrower's assets. The borrower held inventory, equipment and AR securing the $33 million debt.

#3 Lender's Top Frequently Asked Questions

JUNE 23, 2009

The Ox and the Ditch: Frequently Asked Questions About Under Performing Commercial Real Estate Loans

This is a special series of blog entries in which we provide some quick answers to lenders' frequently asked questions (FAQ). Two things should be kept in mind. First, none of these questions can be answered in a vacuum. Questions should be considered with a thorough review of the file and an interview with appropriate loan officers. And secondly, many of the questions are worth revisiting from time to time because subsequent events will impact the answers.

1. The borrower is how far behind—now what?

- Analyze the entire situation: The collateral, the loan documents, the file, any co-lender or intercreditor agreements, financials on the parties, the market—in other words, the entire picture. Act like you're about to own it.
- Consider restructuring: But send a "Discussion Letter"—to help avoid waiver of lender's rights under the loan documents.
- Determine whether a default has occurred—as defined in the loan documents. If so, consider sending Notice of Default and Notice of Acceleration.

2. What if the default was not a monetary default?

- "Default" vs. "Event of Default:" Check defined terms in the loan documents.
- Look for grace/cure periods to see if expired.

3. What can I do besides calling a default?

- Alternatives to calling a default include restructure (i.e., amend the loan documents so the borrower is no longer in default—if the borrower's financial deterioration is not too great).
- Simple Notice of Default—Just create a written record that it exists and is continuing.

4. Do I need to reduce the commitment amount after sending a Notice of Default?

- Typically, no—once the loan is declared to be in default, or once the maturity of the loan is accelerated, the lender has no on-going funding obligation—but confirm this in the documents.
- The lender typically is not required to fund current loan allocations or grant new loan allocations.
- Communicate clearly in writing to the borrower that negotiations, inspections, administrations and even making future draws during a draw period (whether under a construction loan or a partial disbursed loan) do not amount to waivers of pre-existing defaults or can be considered obligations for future fundings.

continued

5. After a Default Notice, should I send statements showing regular monthly interest or statements showing interest at the default rate?

- Statements to the borrower should reflect the Default Rate of interest (rather than the prior regular interest rate), late fees, and any other fees due the lender (such as legal fees)—all of which usually do not appear in the "standard" statement.
- So, typically it is best to STOP sending the regular monthly statements.

6. What else should I put in writing?

- Agreements regarding interim or protective advances
- Forbearance Agreement

All of these first six questions underscore the fact that the status of the property and the loan must be looked at with current and fresh eyes so that the opportunities for solutions are enhanced and the risks of encountering questions or waiver are avoided.

7. Should I pay the property taxes prior to foreclosure?

- Taxes and Escrows: Escrows may be in your possession and available for tax payments—and taxes should typically be paid prior to foreclosure in order to add them to the loan deficiency amount—unless it is your plan to sell at foreclosure subject to taxes to a third party.

8. What other legal issues or hurdles should I consider in proceeding with foreclosure?

Each state's law will govern when and how a lender proceeds with foreclosure. The following questions should be reviewed:

- Is there an anti-deficiency statute or single cause of action rule?
- What are the mechanics lien filing periods?
- What are the content and timing requirements for sending notice of default and acceleration?
- How does my course of dealing affect the existence of the default?
- Can I suspend financing or additional advances?
- What are third parties that may have rights or liens?
- Can and how do I obtain rents and foreclosure on other personal property (i.e., UCC Article 9 remedies)?
- How can I enter the property to protect and preserve it—do I have a right of entry?

9. How do I deal with the Borrower?

Analyze the Borrower's perspective:

- What is the borrower's legal position?
- What are the lender's weaknesses?
- Can the borrower avoid personal liability?
- Who are the guarantors and what is their position?
- What is the borrower's tax position? Is the borrower concerned about forgiveness of debt (as income)?
- What business or project issues are there?
- Does the borrower want to keep cash flow and therefore avoid bankruptcy?
- Is the borrower likely to file bankruptcy?

10. What are the risks for lender liability?

- Waiver
- Misrepresentation
- Good Faith, Fair Dealing (breach of)
- Risk of Improper Disclosure (tortious interference with business relationships)

11. What can I say to the Borrower?

Oral Communication Tips (best practices):

- Attitude: Be calm, cool and factual.
- Truth: Stick to the truth, keep your statements fair and in good faith.
- Loan Documents: Know your loan and do not contradict.
- Notes: Take written notes, but be careful since they might be read in court.
- Power of Two: All conversations should include at least 2 lender personnel.
- Disclaimers: At the beginning of a conversation, state clearly you have no authority to bind the lender, the call is merely to collect information.
- No Threats: Never threaten a criminal complaint or civil suit.
- No Oral Agreements: Make clear that all agreements must be in writing and you will follow up with a written agreement for their review.
- Stick to Your Business: Only make statements within the scope of the lender's business—never suggest ways for the borrower to run or improve its business, i.e., avoid statements such as "you'd make more money if …"
- One-Sided Deals: Avoid suggesting structures that solely benefit you. A decision that solely benefits the lender may come back to haunt you.
- Do NOT record conversations.

#4 Key Differences Between CMBS Loans and Portfolio Loans in the Loan Default Scenario (Part 1 and 2)

JANUARY 22, 2009

In the commercial loan default scenario, CMBS Special Servicers are not able to provide to borrowers many of the accommodations that may be provided to borrowers by portfolio lenders. CMBS Special Servicers are subject to many more restrictions and limitations than to which portfolio lenders are subject in a loan default situation.

Understanding the key differences between CMBS loan workouts and portfolio loan workouts will facilitate a borrower's efforts in attempting to address a CMBS loan default with a Special Servicer. Some of the key differences between CMBS loan workouts and portfolio loan workouts are as follows:

Standards. A portfolio lender applies its own individualized standards in addressing a loan default; and a third-party servicer will administer the loan in accordance with the servicing standard articulated in its servicing agreement with the lender. A CMBS Special Servicer must administer the loans in accordance with the Servicing Standard set forth in the applicable Pooling and Servicing Agreement (the "PSA") and comply with REMIC rules to protect the federal income tax-free status of the REMIC Trust in which the CMBS loan is pooled.

Continuity of Relationship. A portfolio loan has continuity in the origination, servicing, and workout of the loan. The portfolio lender has an ongoing relationship with the borrower and retains tight control over any third-party loan servicer. On the other hand, a CMBS loan involves the fragmenting of the obligations, responsibilities, and liabilities for the loan between multiple parties involved.

Workout Goals. A portfolio lender attempts to preserve the value of the asset and, in some instances, its relationship with the borrower. A CMBS Special Servicer attempts to preserve the integrity of the Trust, while maximizing recovery for the bondholders.

Preemptive Abilities. A portfolio lender may make additional loan advances or enter into preemptive loan modifications to address a potential loan default. A Master Servicer typically lacks the ability to preemptively address a potential loan default.

Due Diligence Review. A CMBS Special Servicer's review of due diligence may be more challenging than that of a portfolio lender because the Special Servicer is often not familiar with the loan before the transfer of the loan from the Master Servicer to the Special Servicer (i.e., the "Servicing Transfer Event").

Flexibility. Due to REMIC rules and the restrictions and limitations set forth in the PSA, a Special Servicer is not able, or has less flexibility than a portfolio lender, to substitute collateral, take additional collateral, capitalize past due interest, bifurcate the debt, take an equity or contingent interest position, operate an REO property, or lend additional money as a loan default solution.

No CMBS Loan Dragnet Clause. The borrower has no other source of repayment for a Special Servicer to consider in the workout of a CMBS loan, which may not be the case in a portfolio loan workout scenario.

SPE Provisions. A CMBS loan borrower is bound by bankruptcy-remote SPE provisions in its organizational documents.

a) Bankruptcy Remote: There are structural impediments to the borrower's ability to file bankruptcy. Even if the borrower files bankruptcy, the CMBS lender is likely the only secured creditor.

b) Single Purpose: The borrower has no ability to substitute or add collateral to address a CMBS loan default.

Carve-out Guaranty. While many portfolio loans are recourse loans, CMBS loans are typically non-recourse. With respect to a CMBS loan, the borrower and the principals of the borrower may face recourse liability for certain bad acts described in the loan documents.

Cash Management. Many CMBS loans have a lockbox cash management component that facilitates the control of cash collateral. Portfolio loans typically do not have any such component.

Regular Borrower Financial Reporting. While portfolio loans typically do not have rigid borrower financial reporting requirements, regular borrower financial reporting requirements of a CMBS loan keeps the Servicer apprised of the financial status of the real estate collateral. The information in such financial reports may be critical to a Special Servicer in making an informed decision about how to address a loan default.

Property Management Control. CMBS loans typically assign to the lender the right to replace the property manager with a lender-approved property manager. Portfolio loans typically do not have any such assignment provision.

The differences between the two types of loans are significant. And this list is not all-inclusive. So, be careful–and as self servicing as this sounds, use legal counsel who is experienced in handling CMBS loan workouts.

#5 Uncertain Waters: Scorecard on the CMBS Market

NOVEMBER 24, 2009

By now you should be well aware of this "bad" fact stemming from failure or lock-down of the CMBS loan market:

Between now and the end of 2012, more than $600 billion of CRE loans will mature in EXCESS of the average 3-year historical gross originations from all non-commercial CRE lenders. In other words, in the absence of a CMBS loan origination market, +$600 billion of CRE loans will mature with no historical source for pay-off.

"Between now and the end of 2012, more than $600 billion of CRE loans will mature in EXCESS of the average 3-year historical gross originations from all non-commercial CRE lenders"

To put this another way, if the loan is within the tight bandwidth of the best underwriting standards (for example, high debt-service coverage and low loan-to-value), then the loan probably will find a refinancing source. If it is not, then there simply isn't credit available to repay the loan. Thus, the lender/servicer has two choices: extend the loan or foreclose.

This gives you a good perspective of the "why" behind the "extend and pretend" approach adopted by banks and CMBS servicers.

So, for all those loans that are not in the tight bandwidth, where are we on the all-important topic of jump starting or replacing the CMBS market? (Show us the money)

Here's a quick scorecard that indentifies a few recent milestones:

New CMBS Issuances!! Yes, two new issuance of CMBS hit the market last week. It has been nearly two years since the last sale of new CMBS issuance. While it is an important first step, the DDR Depositor LLC Trust 2009 Commercial Mortgage Pass Through Certificates (series 2009 DDR1) signals little hope for the typical CRE investor: this CMBS pool is a single sponsor structure, with low loan-to-value (@ 62%), great debt-service coverage (@ 1.4x), and a significant percentage of investment-grade tenants (@23% of total square footage and @15% of base rent). And the same can be said of the second issuance, which was the Bank of America Large Loan Trust 2009-FDG. The BoA deal was a single, seven-year, fixed-rate non-recourse loan to entities of Fortress Funds. Neither issuances, however, involved a pool of small loans from a wide variety of borrowers.

While something is better than nothing, these two issuances do not signal immediate help to the typical owner. Bottom line: great news for Wall Street; no help for Main Street.

Basic Changes to the CMBS Model - Risk Retention. The Hill seems to be listening to the CRE industry. In September, the CMSA issued a white paper (PDF) giving input on the 2009 Financial Regulatory Reform proposals currently being studied by Congress—but from the perspective of the commercial mortgage market. Last week, the House Financial Services Committee passed an amendment to the reform bill that (i) places the risk retention requirement at 5% and (ii) recognizes third-party investors (who purchase the first-loss position and re-underwrite all loans during pooling) as proper holders of the risk retention piece. This is an important victory for the CRE industry.

Rating Agencies in the Spotlight. Part of the reform includes changes in the role and function of the rating agencies. My perspective is that we really haven't heard much from the most important player in the mix: the investor. (The party who literally "buys" the CRE investment, whether in the form of a CMBS bond or a limited partnership interest.) For a hint of the investor's perspective, read this white paper (PDF) from the Council of Institutional Investors (Web site). It strongly argues for more accountability on the part of the rating agencies. At the very least, this points to the fact that the "re-examination" of the CMBS recipe is wide ranging. And with topics such as rating agency liability on the table, I doubt that there will be a quick fix. And, as noted above, the "table" is located on the Hill, which is not a friendly banquet hall for commercial real estate . . . .

More Extend and Pretend. What does a "no quick fix" mean? Navigating the CMBS ship through the political process will NOT be a quick trip. Consequently, for loans that are nearing maturity, or are in distress, the rescue plan will involve the current lender for the next 12 months. At the loan level, it will take creativity and a thorough understanding of the market and the lender/servicer constraints (such as the new guidelines for banks or the PSA limitations for CMBS servicers), in order to keep the loan out of foreclosure.

#6 Evaluating Material Adverse Change (MAC) Clauses in the Loan Default Context (Part 1 and 2)

MAY 7, 2009

In an earlier posting we briefly covered the important distinction between a "monetary" default and a non-monetary default. One non-monetary clause getting increased attention is the "material adverse change" clause.

Commercial lenders often include Material Adverse Change (MAC) clauses in their loan documents, especially in transactions involving the release of funds over time, such as credit facilities, revolving lines of credit or cash advances on asset-based transactions or in real estate transactions, earn-outs or some other form of future funding. A MAC clause is typically broad and provides that the occurrence of a "material adverse change" constitutes an event of default by the borrower under the loan documents. A "material adverse change" is then defined to include changes in business, operations or the financial condition of the borrower.

Lenders typically are cautious in declaring that a borrower default under commercial loan documents has occurred as a result of a "material adverse change." The more broad the MAC clause, the more uncertainty the lender has in evaluating whether the MAC clause is applicable to the alleged "material adverse change."

Case law may also deter lenders from declaring a borrower default based solely on a broad MAC clause. Courts have not yet developed a standard test in evaluating MAC clauses. Courts will carefully review the language of the MAC clause and the extrinsic evidence, if necessary, to determine whether the MAC clause is applicable.

In the event the lender declares that a borrower default under the loan documents has occurred as a result of a "material adverse change," a lender should be prepared for the borrower to contest such default declaration in the event the answer to any of the following questions is "Yes":

1. Is it unclear whether the change at issue is "material" and "adverse?"

While determining whether a particular change is "adverse" is somewhat straightforward, determining whether the change is "material" is typically a challenge in the context of a broad MAC clause.

Lenders intentionally do not define the term "material" in the MAC clause. Lenders want the MAC clause to cover all unknown and unforeseen adverse changes.

Materiality is a fact-based determination and highly dependent on the circumstances of each case. There is no baseline percentage or threshold amount that is deemed to be "material," absent specific language in the document. Given the fact-sensitive nature of the issue and the broad language of a typical MAC clause, courts typically consider a broad MAC clause to be ambiguous and require extrinsic evidence to determine the parties' intent as to what types of changes the clause was intended to cover. Any litigation on the issue will likely require a full-blown trial because summary judgment cannot be obtained under these circumstances.

Each party should carefully review the loan documents to determine whether any specific objective thresholds are included in the loan documents with respect to whether a particular change is "material" under the MAC clause.

Each party should also determine whether the loan documents contain any specific exclusions to the MAC clause. In the event specific changes are expressly excluded from the MAC clause, and the particular change deemed by the lender to be "materially adverse" is not an express exclusion, a court may view such non-excluded change to be subject to the MAC clause.

Each party should review its file with respect to prior loan document negotiations. If the borrower requested that the particular change deemed by the lender as being "materially adverse" be excluded from the MAC clause (and such requested exclusion was ultimately not accepted by the lender), the exclusion may be used by the lender as evidence of the parties' intent that the MAC clause cover the requested exclusion.

2. Do the loan documents contain a subjective MAC clause and require the lender to act reasonably or in good faith?

If the loan documents contain a subjective MAC clause, the borrower should review the loan documents to determine if the lender has a duty to act in "good faith" in determining whether a "material adverse change" has occurred, or whether such determination must be "reasonable." Furthermore, in interpreting the meaning of a subjective MAC clause, the parties should each determine whether "reasonableness" and "good faith" standards are implied by the particular state laws governing the loan documents.

3. Are there multiple inconsistent MAC clauses in the loan documents?

In the event the loan documents contain multiple inconsistent MAC clauses, a question of fact may arise as to whether the MAC clauses are enforceable.

4. Is the language of the MAC clause unclear?

The parties should pay particular attention to word choice and consider every word in the MAC clause in light of the circumstances of the particular transaction. Exacting language is particularly critical with respect to any negotiated carve-outs from the MAC clause. In addition, all applicable definitions must be carefully examined.

#7 Steering Through CMBS Waters: A Primer for Troubled Loans

NOVEMBER 5, 2009

It's Monday morning and you're getting ready for work with the news on the TV in the background. By now, you're practically immune to the daily dose of doom and gloom that has become business news, particularly with regard to real estate and mortgage-backed securities. So you're not overly concerned when you hear the anchor say, "Vital signs are dangerously low in the commercial mortgage-backed securities market. We're suffering from a trifecta of decimated bond prices, weakening mortgage performance and drastically reduced loan originations. The threefold combination has pummeled portfolio values and deprived borrowers of a primary source of commercial real estate financing." As you turn off the television and head out the door, you find solace in the fact that you work for a public healthcare company and not a financial services firm.

Your phone is ringing as you walk into your office. It's your CFO explaining that a $5 million loan on one of your office buildings in Michigan is maturing in three months. He asks you to help the company's internal business unit that is desperately searching for new financing while, at the same time, communicating with the commercial mortgage-backed securities (CMBS) loan servicer who manages the loan. Did he just say CMBS? Loan servicer? Find financing upon maturity? What do you need to know about the CMBS industry and its participants to navigate through this mortgage mess that just fell into your lap?

Visit **toughtimesforlenders.com** *to* read the complete article.

Article originally published in the September issue of *American Corporate Counsel* (ACC) *Docket,* the award-winning journal of the Association of Corporate Counsel.

#8 SARE Cases Causing Big Stir in Bankruptcy Courts

AUGUST 27, 2009

What is a SARE case?

SARE stands for *Single Asset Real Estate* and is commonly used to describe bankruptcy cases involving debtors who own a single real estate parcel or project. Given the economic climate, we have seen a recent surge in SARE bankruptcy filings and Winstead currently represents numerous secured lenders in SARE bankruptcy cases.

What is special about a SARE case?

The 2005 amendments brought several changes to the Bankruptcy Code's treatment of SARE cases. First, Congress removed the $4 million dollar maximum secured debt limit in order to qualify as a SARE. Accordingly, the SARE designation can now apply to both large and small debtors alike. This has opened the door for more (and larger) entities to meet the criteria of a SARE debtor.

Congress also expanded a special adequate protection rule for SARE cases. The SARE amendments responded to complaints by secured creditors that real estate cases were often abusive and filed only for purposes of delay while debtors hoped for a local real estate market recovery. The SARE provisions are designed to ameliorate this problem by forcing the debtor in such cases either to propose a workable plan promptly or to start making monthly interest payments to the secured creditor. Failure to do either will lead to a lifting or modifying of the automatic stay. The Bankruptcy Code now provides for a lifting of the stay if by the later of: (i) 90 days after entry of the order of relief (generally the bankruptcy filing date); or (ii) 30 days after the court determines the debtor should be designated as a SARE, the debtor has not filed a plan of reorganization that has a reasonable likelihood of being approved within a reasonable time or commenced monthly interest payments to the secured creditor.

What are the effects of the amendments on current bankruptcy litigation?

A SARE debtor should designate itself as a SARE debtor when it files for bankruptcy. However, there has been a significant amount of recent litigation ensuing when such a designation has not been made, usually as a result of a motion filed on behalf of the secured lender seeking to designate a case as a SARE case. This upward trend in litigation will likely continue as debtors attempt to bypass the SARE protections afforded to secured lenders under the Code. SARE designation can be a little tricky since the property in question must be "passive income" in order to qualify for SARE designation. For example, hotels generally do not qualify for SARE treatment due to the "business" nature of the income. Since the SARE lift stay provisions are measured from the later of 90 days after the bankruptcy case is filed or 30 days after the date the court determines a debtor is a SARE debtor, Winstead has advised its secured creditor clients in SARE bankruptcy cases to quickly file a motion to designate the case as a SARE case in order to avoid any uncertainty as to whether the SARE restrictions and deadlines apply.

#9 Ticking Sound: Review Your Title Insurance - A Quick Checklist (Part 1 and 2)

SEPTEMBER 23, 2009

No surprise at this statement: When the real estate mortgage nears the ditch, the lien priority of the loan and the status of the title (such as easements, deed restrictions, access rights and lien priority) all come under scrutiny.

One important point of inquiry is the title policy covering the loan. An "audit" or review of the title policy should be done.

Here's a quick (albeit incomplete) list of things that should be investigated (in no order of priority):

Is there a title policy? (Don't be shocked if you don't have a title policy—this is one of those "details" that can get "lost" during the post-closing/servicing process).

If it is a construction loan, was a policy purchased or is a "binder" merely in place? (If a binder, can or should a policy be purchased? Is this possible or even desirable?)

- What is the current coverage amount?
- What is the date of the last down-date?

Do you need to put the title policy insurer on notice of a possible claim? (Read the title policy for "how" to do this).

Do you have a complete copy of the title policy, the title policy exception documents, and the title policy endorsements? (You'll be amazed at how many loan files fail to contain all of this).

Does the title policy:

- Continue to cover an affiliate of the lender that takes the title at foreclosure or a transfer in lieu of foreclosure?
- Correctly describe the insured land?
- Contain the correct amount?
- Have the correct title policy form with all endorsements?

Was UCC insurance obtained (covering attachment, perfection and priority of lender's security interest in personal property)?

Here are the types of transactions where UCC insurance is important:

- Factoring credit facilities (where the collateral includes a right to payment or claim covered by a UCC filing).
- Mezzanine loans (where the collateral is ownership interests in the borrower entity) covered by UCC filings.
- Asset-based credit facilities (for example, where collateral includes inventory and accounts receivable covered by UCC filings).
- Mixed collateral structures (for example, where collateral includes both real and personal property—such as a hotel or a restaurant).

Title insurance polices can contain a long listing of "exclusions" from coverage. There are items that are not covered by the policy. These can include the following, each of which can limit the use and value of the collateral: easements, restrictions, use agreements, development agreements.

- Do these exclusions impact the current use and physical attributes of the collateral?

Note that zoning compliance and building code restrictions typically are not included in the basic title insurance coverage. Therefore:

- Does the policy contain a zoning endorsement?
- If "yes," then what are the terms of the endorsement?
- Has the current use and physical attributes of the property changed since the issuance of the endorsement?

Note that a zoning endorsement to a title insurance is a separate and distinct topic from ordinance or law casualty insurance. Apples and oranges.

Does the title policy (and endorsements) in the file contain the terms requested at loan closing?

- For example, if the removal of the "creditors' rights" exclusion was requested at closing, was it removed (or endorsed "out") from the policy? A "creditors' rights exclusion" removes creditors' rights issues from coverage of the policy—such as fraudulent preferential transfers.

Note that creditor rights commonly present risks in these types of transactions:

- Multi-collateral with separate SPE or "single purpose entity" ownership entities
- Leverage buyout transactions

#10 More on That Ticking Sound: Don't Forget to Obtain or Verify Insurance Coverage

MARCH 26, 2009

Here's another topic from our "Ticking Sound" series covering insurance issues and environmental issues:

The subject of insurance for foreclosed properties doesn't seem to come up very often, most likely because there are so many other more pressing problems to worry about. But failing to ensure that the property has adequate insurance—not just "trendy" coverage like environmental impairment insurance but also "old fashioned" property, liability and flood insurance—is absolutely vital to avoid problems that arise all too often.

A lender, servicer or foreclosure purchaser's analysis of insurance on foreclosed property should start with the working presumption that the borrower's insurance will not protect the lender, servicer or foreclosure purchaser after the property is transferred. This may not be so, particularly if care has been taken on the front end to ensure that the lender is included as a named insured on applicable policies, but it still is possible (if not quite likely) that the borrower quietly cancelled the policies to pick up any premium refunds that might be available. Even if the borrower did not resort to such a tactic, the transfer of title from borrower to lender may deprive the borrower of an insurable interest in the property, without which the policy may be void. Some policies also include exclusions or other provisions limiting or precluding coverage for abandoned property, and when the borrower walks away, these provisions may be triggered. The result can be a nasty surprise when a claim occurs later.

How to avoid such issues?

The best way is through careful analysis at the time the loan is underwritten and active management of insurance issues throughout the life of the loan. Many commercial loan agreements contain provisions that allow lenders to take an active role in making sure insurance coverage is up-to-date and appropriate. [See, e.g., *Omni Berkshire Corp. v. Wells Fargo Bank, N.A.,* 307 F. Supp. 2d 534 (S.D.N.Y. 2004)(requirement in loan agreement that borrower purchase "other reasonable insurance" as required by lender allowed Bank to require New York hotel to purchase $60 million in terrorism coverage after 9/11 attacks)].

But even if this is not possible, there may yet be ways of solving the insurance problem. Many insurance policies are assignable, and it may be possible as a part of a workout to obtain assignment of the borrower's policies to the lender. The lender may also have pre-existing arrangements with insurers, such as portfolio policies that allow it to make the transfer of coverage relatively painless. Whichever route is taken, however, the lender at foreclosure should stop and assess the adequacy of the insurance on the foreclosed property: Are values adequate? Will there be coinsurance issues? Is the property located in an area where there is adequate flood coverage? Is there coverage for my liability as a property "owner" or "operator" for premises liability and other problems?

Answering these bread-and-butter questions and others like them with the help of appropriate legal and insurance professionals can help lenders, servicers and foreclosure purchasers avoid many of the pitfalls that follow from acquiring that piece of collateral.

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