

LESSONS LEARNED FROM THE DOWNTURN

DISCUSSION FACT SCENARIO

Community Retail Center – Anchor tenants are a national bookstore and a movie rental store

- Owner has defaulted on mortgage payments, due to tenant rental defaults
- There are outstanding deferred maintenance items, such as parking lot repairs and a few roof leaks, which are the owner/landlord's responsibility
- Property taxes are delinquent
- Lender has just exercised its Assignment of Rents and Leases by recording a notice of default and serving the notice on the tenants
- Owner and lender are cooperating to negotiate a friendly foreclosure/deed in lieu
- Movie Rental Store is out of business, so space is dark; tenant is behind on rent payments; tenant is negotiating with a new Dollar Store to lease this space
- National Bookstore is operating, but is merging with a competitor that has a store in a newer competing retail center in the area; tenant is paying rent; tenant is also seriously considering closing this store
- In-line national, regional, and local retailers/restaurants – several vacancies from tenants relocating or going out of business
- Greeting Card Store has an exclusive use clause in its lease
- Family Restaurant has 2 five-year renewal options, with a tenant improvement allowance for each renewal
- Auto Parts Store subleased from prior tenant is doing well

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THE TROUBLED SHOPPING CENTER: THE OWNER'S PERSPECTIVE

MONICA J. LABE

DICKINSON WRIGHT PLLC
38525 Woodward Avenue, Suite 2000
Bloomfield Hills, MI 48304-5092
P 248.433.7226
F 248.433.7274
mlabe@dickinsonwright.com

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THE TROUBLED SHOPPING CENTER: THE OWNER'S PERSPECTIVE

What was once a vibrant thriving Shopping Center is now a ghost town--store fronts dark and vacant, maybe a few scant tenants remaining. "How did it come to this?" reflects the Owner. "How could I have been making money hand over fist a few years ago and now I am facing losing this Center." It is story being told all over the nation. Unfortunately, in Michigan, this has been going on for a longer period of time than the rest of the country and the prospects of rebound here are less promising.

The domino effect is relatively straightforward: when people lose their incomes, they stop consuming goods. Accordingly, stores become increasingly quiet, sales plummet and retail tenants suffer losses. Tenants are forced to go dark, terminate their leases, and potentially declare bankruptcy.

If there is not enough income from the Center to pay the debt service and expenses, then the Owner has to determine how long it can or wants to keep the loan in compliance by funding it from other sources or seeking a new capital infusion? Does the Owner want to pour good money into a bad proposition? To what extent does the Owner have a choice in the matter? The question often turns on two major issues: (1) what equity does the Owner or Guarantor have left in the Property (how much greater is the value of the property compared to the debt owed) and (2) whether or not the Owner or Guarantor will be personally liable for failure to pay the loan; in other words, what kinds of guaranties were provided, or it is a non-recourse loan, with the customary "bad boy" carve outs (making a "walk away" much more attractive if the Owner's equity is gone). There are also other considerations such as whether the Center is in trouble mostly as a result of the economic downturn such that a rebound could quickly revitalize it or whether it has been in dire straits for some time.

All of these questions, and more, come into play with a troubled Shopping Center. In the current hypothetical, there are two anchor tenants: one was a movie rental store that got behind on payments and went out of business (so this space is dark) and another anchor, a large bookstore (a.k.a Borders) on the verge of leaving due to consolidation with a competitor, making this store superfluous. Smaller national, regional and local retailers fill the spaces in between, but there are several vacancies from tenants relocating or going out of business. The bright lights in this otherwise dismal situation—an auto parts store which subleased from a prior tenant that is doing well and a dollar store interested in taking the anchor space. A greeting cards store has an exclusive, use clause in its lease. A family restaurant occupies a space and has two, five year renewal options, with tenant improvement allowances. The parking lot and roof need repairs, both of which are the Owner's obligations. A limited recourse guaranty has been provided. For this hypothetical, we will assume the Owner/Borrower is a single purpose limited liability company, so its only asset is this Center. "Owner", "Borrower" and "Mortgagor" will be used interchangeably throughout.

1. What Has The Owner Been Dealing With Up To This Point In Time?
 - A. Tenant Issues:
 - i. going dark
 - ii. invoking co-tenancy clauses
 - iii. overall requests to renegotiate lease terms (i.e. reduce the rent)
 - iv. terminating leases
 - v. rent and operating expense arrearages
 - vi. tenants declaring bankruptcy and rejecting leases
 - vii. use restrictions prohibiting re-leasing opportunities
 - viii. repairs and maintenance obligations mounting (those owed by the Landlord under leases or those required by tenants who are not performing)
 - ix. End Result: The Center is not cash flowing to pay debt service under the loan nor the operating expenses for the Center and it's physical condition is deteriorating in the process.
 - B. Issues with the Loan/Lender:
 - i. defaulting on payments
 - ii. violating loan covenants (debt coverage ratios, liquidity covenants)
 - iii. trying to get lender approval on renegotiating/amending leases and new below market leases just to keep the Center going
 - iv. Failing to pay taxes
 - v. Unable to get to the right decision makers to the table in a multi-tier financing
 - vi. If it's a CMBS loan—many more difficulties in sorting out the players
 - vii. End Result: A defaulted Loan with the Lender threatening foreclosure and the exercise of any and all available remedies under the Loan Documents
2. Owner's Due Diligence Strategies At This Point:
 - A. Evaluate the Collateral

- i. Determine the property's value: how much less is the value of the property compared to the debt? What equity, if any, does the Owner have left?
- ii. What are the redevelopment capabilities of the Center?
- iii. Determine what leases are salvageable, which ones will likely be terminating shortly and what other tenant concession requests can the Owner expect.
- iv. What are the prospects for new tenants?
- v. Compliance with the non-recourse carve outs is paramount; if failure to pay taxes turns the loan from non-recourse to recourse or at least a portion, insure that taxes are kept current.

B. Evaluate the Loan Documents:

- i. Determine if there are any deficiencies under the Loan documents or provisions in the Loan Documents that are favorable to the Owner.
 - a) Does the lender have a perfected security interest in the collateral?
 - b) Are all the documents signed and where required, recorded?
 - c) Does the Lender have the original Note?
 - d) All of these potential deficiencies could weaken the Lender's position and increase the Borrower's leverage in a workout.

C. Evaluate the Parties

- i. Lender(s):
 - a) Are their multiple tiers of lenders?
 - b) How are these loans structured/subordinated to one another?
 - c) Is there a mezzanine lender?
 - d) How does this lender fit in to the picture?
 - e) Who does the Borrower need to communicate with?
 - f) Multi-tiered financings, the interrelationship of these loans and how a Borrower default impacts each must be evaluated. Was an Intercreditor Agreement executed?

- g) If this is a CMBS loan, there will be further involvement of a master servicer, principal servicer and special servicer.
 - h) It is a quagmire of players with different and often competing interests. Inaction and failure to make any decisions is to the advantage of the Owner if it wants time to turn the Center around or find re-financing (and it is non-recourse debt). Where there may be recourse liability for Guarantors, this stand-still or limbo can cause extraordinary hardship.
 - i) Determine potential lender liability: excessive control of Borrower may result in lender liability (paying Borrower's bills directly, deciding which bills should be paid, involvement in Borrower's business decisions, etc.).
- ii. Borrower:
 - a) Is it a single purpose entity whose only asset is the real estate? In this hypothetical, yes.
 - b) Creating a chart of the capital stack is the best way for borrower's counsel to understand the various lending entities it will likely have to deal with in a defaulted project. Which lender or lenders has the borrower communicated with thus far? If this is a CMBS loan, then identify the master servicer, primary servicer, and special servicer as well as rating agencies.
 - c) Borrower's counsel should create a chart of every member of the LLC and determine what are each members' interests and their respective liabilities. Who is obligated to put in additional money in the project under the LLC's Operating Agreement? What are the dynamics between the members of the LLC and the guarantors? What consents are required under the Operating Agreement for any and all anticipated actions to be taken under the workout? Obtaining separate counsel for members of an LLC (and the guarantors) is recommended due to inherent conflicts of interest.
- iii. Guarantor:
 - a) Is there a guaranty. Is it a guaranty for payment or collection (or both)?

- b) Pay particular attention to whether the guarantor's liabilities have been limited under the Loan Documents (and what happens to those limitations in the context of a default).
- c) Do certain defaults trigger nonrecourse debt to become recourse and does it cause the entire loan to become non-recourse or only recourse with respect to specific "bad boy" carve outs.
- d) Terms: partial or full/ fixed or sliding/ top or bottom/ first or last dollar paid
- e) See US v. Leslie, 421 F2d 763 (6th Cir 1970), which found that the lender can simultaneously foreclose by advertisement and sue third-party guarantors.

D. Analyze the Current Default(s). The Owner should analyze what notices of default have been received thus far, and determine if there have been any deficiencies in the notices (for leverage later). Also, are there defaults for which no notice has yet to be provided? If a workout is contemplated, then the Owner will need to disclose all defaults of which it is aware.

E. Analyze the Collateral. Where the Lender will be doing a detailed analysis of the Shopping Center collateral, its strengths and weakness, the Borrower knows the Center well. This is one of the best arguments it can make to the lender in terms of agreeing to do a workout versus the lender exercising its remedies against the collateral and/or obligors. The Borrower may be the party in the best position to continue to manage and operate the property. So, if the Borrower desires to stay in the game it can make a viable argument to the lender to this effect. It can make its case by having a clear plan on how it will turn the Center around.

3. Should the Owner Stay or Go? Workout or Walk Away (or at least try to walk away). It depends on several factors:

A. Does the value of the property exceed the debt? In other words, is there equity worth saving? If the answer to this question is in the affirmative, then the Owner will more likely desire to restructure/workout this loan. It is worth it to stay in the fight. However, if the answer is no, then the Owner will need to evaluate how long it will take to recoup the value and what are the chances of this happening within that time frame. If the prospects are poor on both fronts, then the Owner's path will likely be much different, with the Owner merely attempting to stop the expenditures from mounting and tee up the property for a deed-in-lieu of foreclosure.

In the hypothetical, the loan is underwater (property worth less than the debt) and the prospects don't appear good for revitalizing the Center or refinancing. As such, the course is much more likely to be negotiation of a deed-in-lieu of foreclosure.

- B. Recourse or Non-Recourse Liability? If it is non-recourse liability, then the Borrower has much for leverage and flexibility—such that walking away or staying will simply be a matter of whether or not and to what extent Borrower has equity in the Center. In this hypothetical, the Guarantor provided a limited recourse guaranty. This means the guaranty is limited to the "bad boy" carve outs only so you would consider this as close to non-recourse liability as you can get. The much more difficult position is where the Borrower has no equity and the guarantors have personal liability (and have assets to make such a suit viable). In such instance, the Lender has in its arsenal a lawsuit against the Guarantor, which is significant leverage. Usually in this case, since the Lender likely does not want the property, the Lender may be able to negotiate pay downs on the principal in exchange for its agreement to forbear.
- C. Other issues to consider:
 - i. What are the tax implications of putting more money into center and trying to work it out versus DILF or foreclosure?
 - ii. Are there other more worthwhile properties the Owner is trying to save so that this Center is a drain on the Owner's finances?
- D. If there is equity, can the Owner and Lender work it out? What would be favorable economic terms of a workout from the Owner's perspective:
 - i. interest only loan or reamortization
 - ii. temporary reduction in interest
 - iii. extend maturity date
 - iv. as little reserves as possible (best case-- none)
 - v. no principal pay downs
 - vi. no additional security
- E. What the Borrower is more likely to face:
 - i. some kind of principal pay downs
 - ii. loan may become interest only, with interest at a higher interest rate than the contract rate

- iii. establishment of reserves for taxes, insurance, interest (at a higher rate of course)
- iv. Lender looking for additional collateral to secure the debt—is there any other property or interests to secure the existing debt, such as a pledge of the Owner's membership interest perhaps, other real estate that can be mortgaged, setting up a cash collateral account, etc.).

4. Begin the Negotiations—The Pre-negotiation Letter

A. Once the Borrower has received the notice of default, the Borrower may decide to reach out to the Lender for preliminary discussions of potential options. At this time, the Lender will customarily send a Pre-negotiation Letter (to be countersigned by the Borrower and all Guarantors), which contains the following terms:

- i. These are discussions only and that no deal is made until a written agreement is signed by both parties.
- ii. Borrower reaffirms the validity and enforceability of the Loan Documents and reserves all rights and remedies as provided in the Loan Documents.
- iii. A statement of the debt owed is often included.
- iv. Borrower acknowledges it will be responsible to pay all attorneys fees and costs and all other amounts due under the Loan Documents. (*Borrower strategy: limit this to what is set forth in the Loan Documents, not in addition to*).
- v. Borrower shall acknowledge it is represented by independent counsel and understands the terms of the pre-negotiation letter and is under no duress to execute the same.
- vi. Loan Documents are still in full force and effect and no verbal discussions or written proposals will modify this unless and until a mutually acceptable agreement is executed by the parties, neither of which party is obligated to execute.
- vii. Both parties do not waive any rights or remedies by entering into these discussions and attempting to structure a workout.
 - a) *Borrower Strategy: Be sure that the Pre-Negotiation Letter does not contain any waivers of claims the Borrower may have against the Lender. Some lenders may be aggressive and try to include such a waiver in this very preliminary document.*

- B. Term Sheet – In complex workouts, it may be worthwhile before jumping into an actual agreement to document the terms of the workout in a term sheet. Both parties will want to reiterate that the term sheet is non-binding and include a provision that the term sheet is provided as a settlement document and is entitled to protection from disclosure or use in any evidentiary proceeding pursuant to Federal Rule of Evidence 408, Michigan Rule of Evidence 408, or any other similar statute, rule of evidence or common law prohibiting the use of statements undertaken for settlement purposes.

5. Documenting the Workout: Forbearance and Loan Modification

- A. Overall: In a Forbearance Agreement, the Lender agrees to forbear from exercising its rights and remedies with respect to certain identified defaults for a defined/limited period of time. In a Loan Modification Agreement, there is a restructuring/modification of the existing loan terms so that the Borrower is able to comply with these terms while the Lender's collateral remains protected and even enhanced (as consideration for agreeing to the modification). Whether it be a Forbearance Agreement or Loan Modification Agreement, the terms will be similar.

- i. *Borrower Strategy: Lender will want to include the Guarantor as a signatory to the Agreement. The Borrower should only agree that the Guarantor executes a reaffirmation agreement, where it will acknowledge and consent to the terms of the Agreement and that the Agreement does not nullify or modify its obligations (and the Lender's rights and remedies) under the Guaranty, except as modified by the Agreement).*

- B. Forbearance Agreement Terms¹: What the Borrower can expect and how to best negotiate these terms:

- i. **Acknowledgements by the Borrower:** Acknowledge all Defaults; the identified debt is and continues to be owed to Lender without set off, defenses, or counterclaim; obligations are secured by valid, perfected, indefeasible, first-priority liens in Lender's favor in, among other things, the current collateral; Lender has fully performed all of its obligations under the Loan Documents and applicable law; Lender's actions have been reasonable and appropriate

¹ Some of these terms below may also be contained in the Loan Modification Agreement, such as acknowledgment and reaffirmation of obligations, amendments to documents, representations and warranties, fees, conditions precedent, etc.)

under the circumstances and are within its rights under the Loan Documents and applicable law; Lender has no obligation to make loans or other financial accommodations available to Borrower and, due to the Specified Defaults Lender has the right to enforce its rights under the Loan Documents and applicable law at any time without notice (as modified by this Agreement); the Agreement and the other Loan Documents were entered into in exchange for good and valuable consideration.

a) *Borrower Strategy: Include knowledge qualifiers where applicable. Try to eliminate the language that the actions of the Lender have been "reasonable".*

ii. **Reaffirmations Made by the Borrower:** Of its obligations and duties under the Loan Documents²; reaffirm the liens in the collateral that it granted to Lender under the Loan Documents; agree that it has and will receive direct and substantial economic benefit from all obligations and all other loans or financial accommodations that Lender may make to the Borrower.

iii. **Events of Default:** Delineate what constitutes an “Event of Default” under the Agreement and the other Loan Documents:

a) If the Borrower does not comply with any term in the Agreement, the other Loan Documents (other than the defaults that have been identified—the “Specified Defaults”), or any other present or future agreement between the Borrower and Lender;

b) If a Specified Default worsens (*Borrower strategy: eliminate as this is a subjective standard*);

c) If a default or an Event of Default, other than the Specified Defaults, occurs under the Loan Documents;

² *Borrower Strategy: Just as it may be impossible to comply with certain representations and warranties due to current problems, it may be similarly impossible to comply with certain obligations and covenants in the Loan Documents. As such, Borrower should attempt a general carve out/exception regarding the same, but the Lender will require specific references be made to identified loan covenants and obligations that are currently in breach.*

- d) If a material adverse change occurs in a Borrower's or Guarantor's financial condition or prospects. *(Borrower strategy: carve out that caused by general market conditions or changes caused or due to required pay downs under the Agreement and qualify that such material adverse change impairs the ability of the Borrower to comply with its obligations under the Agreement or the Loan Documents, as modified by the Agreement).*
 - e) If a judgment is entered against a Borrower or Guarantor *(Borrower strategy: include materiality standard and other qualifications so not just any judgment constitutes an Event of Default)*
 - f) If a Borrower or Guarantor prepays any debts *(Borrower strategy: include parameters or definition of "any debts");*
 - g) If a Borrower or Guarantor makes a false representation or warranty in this Agreement or the other Loan Documents;
 - h) If anyone attaches, seizes, levies, or places a lien on any of collateral;
 - i) If taxes or debts become a lien on any of the Borrower's property *(Borrower strategy: if there are current taxes that have not been paid, make sure to carve these out from this provision).*
- iv. **In a Forbearance Agreement: Agreement to Forbear:** Lender agrees it will forbear from exercising its rights and remedies with respect to the Specified Defaults (and the forbearance shall end on the earlier to occur of expiration of that specified time period or an Event of Default occurs).
- v. **Potential Amendment to Loan Documents:**
- a) Increase the interest rate
 - b) Extend the Maturity Date—Lender may negotiate that principal paydowns correspond with extensions *(Borrower strategy: Negotiate the order of application of the pay downs to the debt—usually operative if there are multiple loans included in the workout and some are recourse to the Guarantor or Borrower).*

- c) Lender will require cross-default and cross collateralization (if not already).
- d) Additional security to be added to the collateral
- e) Capitalization of delinquency: converting interest to principal (there may be issues of usury interest on interest, loss of priority, but these are the Lender's issues)
- f) *Borrower Strategy: Obtain a limitation on personal liability of Guarantor during the period of forbearance in exchange for the additional security being provided (so that the Guarantor's liability is limited to the collateral and additional collateral only during the forbearance period).*
- g) *Borrower Strategy: Attempt to obligate Lender to make future fundings, such as for example, vertical construction loans. It will likely be nonbinding obligation subject to the satisfaction of many conditions, but it is at least an expression of intent.*

vi. **Borrower makes certain Representations and Warranties:**

- a) Regarding Loan Documents:
 - (1) The representations and warranties in the Loan Documents remain in full force and effect (*Borrower Strategy: There may be other reps and warranties in the loan documents that Borrower can no longer make due to current defaults and generally changed conditions and thus those reps and warranties are not in full force and effect. If this is the case, the Borrower should try to carve out these potentially violated reps and warranties from these current representations since the Borrower could literally be in default under the Agreement upon its execution.*)
 - (2) No event of default has occurred that has not been already identified (the "Specified Defaults" concept).

(3) Except for the Specified Defaults the Loan Documents (as modified by this Agreement) may be enforced in accordance with their terms by the Lender.

(4) Borrower has no claim, defense, right of set off or counterclaim against enforcement the Loan Documents and has no other claim against the Lender.

- b) Authority
- c) Compliance/No conflicts
- d) Financial Condition
- e) Ownership of the Property
- f) No litigation
- g) Environmental Condition
- h) Regarding Leases, Rent Roll
- i) Disclosure (no untrue statement of material fact, no fact known to Borrower or reasonably anticipated to have a material adverse effect on Borrower or the Center)
- j) Reliance (is represented by counsel, is fully aware and clearly understands all terms)

vii. **Additional Covenants:**

- a) Additional reporting requirements (*Borrower strategy: define clearly and limit the extent, number of times requests may be made, etc.*).
- b) Borrower continues to be responsible to perform all obligations and covenants under Loan Documents. (*Borrower strategy: limit this to "as modified by this Agreement"*)
- c) Borrower to provide information regarding prospects (as to potential sales, refinancing, etc.) (*Borrower strategy: limit this obligation to signed material agreements*)

- d) Notice of material adverse change in Borrower or the value of the project. (*Borrower strategy: limit this to "financial condition"*)

viii. **Remedies for Default**

ix. **Release of Lender from all claims that exist now or arise later, whether known or unknown, foreseen or unforeseen, or related directly or indirectly to any event occurring on or before the date of the Agreement.**

- a) *Borrower Strategy: Qualify the "arise later" language in terms of matters that arise from facts existing as of the date of the Agreement (but not later) as to any collateral, the loan documents or the Agreement. Clearly limit this to pre-Closing matters.*

x. **Indemnification of Lender as to all claims that may be imposed or incurred by or asserted against the Lender in connection with the Loan Documents and the collateral.**

- a) *Borrower Strategy: Try to eliminate this provision as the Borrower is giving a release but requiring an indemnity is much more onerous.*

xi. **Bankruptcy Proceedings:**

- a) Lender will require that the Borrower agrees to modification of Automatic Stay and that the Borrower acknowledges that the Mortgaged Property constitutes "single asset real estate" under the bankruptcy code.

xii. **Conditions Precedent:**

- a) All monetary defaults have been cured
- b) All fees have been paid
- c) All documents executed and delivered
- d) Escrows have been funded
- e) Title Insurance has been provided

xiii. **Guarantor Issues:**

- a) Reaffirmation of guaranty obligations
- b) Agreement to terms of Forbearance and agrees that there has been no modification or nullification of guaranty obligations as a result of the Agreement

xiv. **Miscellaneous Provisions:**

- a) Extension Options: (*Borrower strategy: negotiate extensions to the Forbearance Period*). Lender will try limit same.
- b) Fees: payment of a forbearance fee and all costs and expenses of Lender, including attorneys fees. (*Borrower strategy: try to limit language to costs and expenses required under the Loan Documents and put in reasonableness qualifiers, or better yet, negotiate a cap on obligation to pay legal fees—which lender will likely reject*)
- c) Appraisals (*Borrower strategy: limit number of appraisals for which the Borrower has to pay*)
- d) ACH privileges terminated
- e) Authorization to Debit Accounts or add amounts to Loan Balance
- f) Waiver of Notice and Cure Periods; Lender's goal is to eliminate all notice and cure periods because Borrower has demonstrated propensity to default. (*Borrower Strategy: Borrower wants to retain what it has or negotiate for shorter periods in exchange for not losing notice and cure period rights entirely*)
- g) Patriot Act Notice
- h) Submission to Jurisdiction
- i) Waiver of Jury Trial

xv. What the Lender may be looking for as consideration for the Workout: Additional Collateral and Additional Principal Pay downs

- a) Other real and/or property to add to the Collateral

- b) Pledges of Membership Interests—issues regarding required consents
- c) Cash deposited into a Cash Collateral Account, which is pledged to Lender as additional security. *(Borrower strategy: Negotiate for pledgor's ability to use cash account for trading Lender-approved marketable securities ,and to trade those freely unless said account falls below a certain threshold.)*
- d) New Escrows for Taxes, Insurance and/or Interest *(Borrower strategy: After a certain period of compliance see if escrows can be eliminated or reduced)*

6. No way to Work It Out—What are the Lender's Potential Remedies?

- A. Deed-in-Lieu of Foreclosure
- B. Foreclosure: Judicial and Foreclosure by Advertisement
- C. Exercise of Assignment of Leases and Rents
- D. Appointment of a Receiver
- E. Sale of the Loan
- F. Discounted payoff
- G. Short sale
- H. Suit on Guaranty
- I. Additional Remedies: Mortgagee in Possession, Action for Waste or Action for Breach of Contract

7. Exercise of Assignment of Rents:

- A. Review specific state laws
- B. Applies for commercial property only.
- C. In Michigan, no foreclosure sale is required--it is a separate and distinct remedy.
- D. The purpose is to capture revenue for mortgagee, which strips mortgagor of operating income and therefore is in conflict with

mortgagor's right to possession of the mortgaged property. After default, and conditioned upon performance of statutory conditions, the mortgagee may collect the rents, despite the mortgagor remaining in possession.

- E. Upon an exercise of the assignment, the mortgagee may thereafter seek a receiver, even if taxes are current. Whether or not the receiver will be appointed is very much in doubt if there is not a showing of waste or some circumstance where harm will come to the property. (*Borrower Strategy: Raise defenses to appointment of a receiver. The Borrower wants to keep control of the Center's income. Once this right is cut off, the Borrower can do very little.*)
- F. Insure the loan documents contain the requisite statutory language creating a security interest in the rents.
- G. There are special rules regarding hotel rents.
- H. Once there is a default under the Loan Documents, the mortgagee's interest in the rents is vested.
- I. Binding on tenants only after a notice of default is recorded with the register of deeds; service of a copy of the notice on the tenants; service on the tenants of a copy of the instrument under which the assignment is made. Often, copy of the notice that was delivered to tenants is served on the mortgagor. (*Borrower strategy: carefully review that the lender followed the required procedure—if not, Borrower has an argument that its exercise was defective*)

8. Deed-in-lieu of Foreclose (DILF): Can the Owner Turn Over the Keys and Simply Walk Away?

- A. Borrower transfers mortgaged property to Lender (or a subsidiary of lender for purposes of non-merger and insulation from liability) in exchange for release from personal liability on the debt. What is the consideration when the debt is non-recourse?
- B. The lender will document this such that the transfer constitutes an absolute conveyance of all of borrower's interest in the property. (*Borrower Strategy: Retain residual interests, such as right of first refusal*).
- C. Must be supported by new consideration (usually a covenant not to sue the borrower and a limited release of guarantor shall suffice, for non-recourse loan, consider the limited negative publicity, ease and speed)

- D. Appropriate where:
 - i. title is clean—there are no intervening liens; and
 - ii. the Property is worth less than the debt
- E. Lender will require a new owner's title insurance policy as well as date down endorsements to loan policy. (*Borrower strategy: Don't pay for these if possible*)
- F. Documents:
 - i. Deed, Bill of Sale, Assignment of Leases and Contracts, Estoppel and Solvency Affidavit (or Deed in Lieu of Foreclosure Certificate), Title/Owner's Affidavit;
- G. Advantages for Borrower: Borrower can limit negative publicity and stop having to pour money into a losing proposition. It stops the bleeding---feels like a walk away if negotiated properly.
- H. Disadvantages for Borrower: Elimination of the right of redemption (but the decision to move forward and do the DILF was premised on the fact that Borrower has no equity in the Property, such that this right is not worth much). Also, the Borrower may have to pay some of lender's expenses it would not otherwise be collectible for and the releases obtained will not limit liability entirely—there will be exceptions/carve outs.

9. Terms of a Deed in Lieu of Foreclosure: Borrower's Goal—walk away with as little residual liability as possible. The terms and conditions will be very similar to a Purchase and Sale Agreement in terms of deliverables, due diligence, representations and warranties and closing conditions because the lender is getting fee simple title to the Center.

- A. Acknowledgments and Agreements to be made by Borrower and Guarantor:
 - i. No waivers by Lender
 - ii. Amount of the Indebtedness
 - iii. Loan Documents are valid and binding and enforceable and security interests are properly perfected.
 - iv. Loan Documents remain in full force and effect and are not released or impaired or diminished in any way or modified as a result of executed of the DILF Agreement.
 - v. Lender's actions are reasonable and appropriate under the circumstances. (*Borrower's strategy: attempt to delete this*)

- vi. Lender has fully performed under the Loan Documents and applicable law. (*Borrower's strategy: add "To Borrower's knowledge"*)
 - vii. Lender has no obligation to make loans or other financial accommodations to the Borrower or Guarantor and because of the Specified Defaults has the absolute right to exercise its rights and remedies under the Loan Documents and applicable law.
 - viii. In consideration of execution of this Agreement (Borrower to acknowledge good and valuable consideration thereof), Borrower agrees not to file for bankruptcy. (*Borrower's strategy: enforceability is at issue with this provision*)
 - ix. The Indebtedness has been accelerated or become due by its terms and is currently due and payable
 - x. Lender granted full and complete access to Borrower's books and the Center and to conduct any audits it desires. (*Borrower's strategy: limit audit rights*)
 - xi. All checks, wire transfers, etc that are the property or proceeds of the Center must be deposited into an account with the Lender.
- B. Property and Interests to be conveyed to the Lender by Warranty Deed (*Borrower's Strategy: a covenant deed should suffice*):
- i. Real Property
 - ii. Personal Property
 - iii. Intangible Property
 - iv. Leases
 - v. Contracts for the sale of all or any part of the Real and Personal Property
 - vi. Security Deposits
 - vii. Claims regarding or connected with construction, management or operation of the Real Property
- C. Absolute conveyance of all interests in the Property and not meant to be an mortgage or security instrument of any kind
- D. No Merger: All Loan Documents remain in full force and effect after Closing and the intent of the parties is the interest conveyed to Lender under the Agreement shall not merge with the interest of the Lender under the Loan Documents, including without

limitation the Lender's fee interest with the Lender's lien under the Mortgage. This language will be included in the Deed.

E. Covenant Not to Sue and Releases

- i. *Covenant Not to Sue: (Borrower's strategy: make the covenant as broad as possible and attempt to get the environmental indemnity waived as well, but the Lender will require certain limitations and carve outs, one of the most important being its ability to still sue on the environmental indemnification)*
 - a) Lender will provide the Borrower with a covenant not to sue the Borrower personally for the Loan and will not seek any judgment against the Borrower to collect all or a portion of the Indebtedness; provided this does NOT (i) preclude action for foreclosure (although no deficiency judgment may be sought against the Borrower); (ii) extinguish the Indebtedness; (iii) impair the lien of the Mortgage or any other Loan Documents; or (iv) restrict Lender's rights and remedies in any foreclosure proceeding (it being understood that Lender will look solely to the Property and profits thereof).
 - b) Notwithstanding the covenant not to sue, Lender may still sue Borrower for indemnification as set forth in the DILF Agreement, any indemnification in any environmental indemnity provided at the loan origination, breach of any rep, warranty or agreement in the DILF Agreement or in any other document delivered at the DILF Closing or if Borrower is a necessary or reasonably necessary party to any action brought against Lender as to the environmental condition of the Property.
 - c) There is no release nor covenant not to sue for any reps, warranties or covenants that survive consummation of the DILF, the full extent of the indemnification in any environmental indemnity provided to Lender or the obligation to pay the indebtedness evidenced by the Loan Documents, it being the full intent that Lender have the opportunity to foreclose the lien evidenced by the Mortgage after title has been conveyed to Lender.
 - d) The covenant not to sue shall be null and void in certain instances, such as Borrower files for

bankruptcy, interferes with any foreclosure action or the Borrower files any claim against Lender relating to the Property or the Loan Documents.

- ii. Limited Release of Guarantor:
 - a) Lender provides Guarantor with a limited release and discharges it from any damages, suites, losses and liabilities Lender may have now or may ever have against Guarantor in connection with the Loan Documents, the Loan and the indebtedness secured thereby.
 - b) The Lender will include specific exceptions to the covenant not to sue such as (i) Lender reserves the right to sue Guarantor for its indemnification as set forth in the DILF Agreement, (ii) any indemnification made by Guarantor in any environmental indemnity provided at the loan origination, (iii) breach of any rep, warranty or agreement in the DILF Agreement or in any other document delivered at the DILF Closing by Guarantor (iv) or if Guarantor is a necessary or reasonably necessary party to any action brought against Lender as to the environmental condition of the Center.
 - c) Specific exceptions to the release will be identified, such as (i) there is no release for breach of any reps, warranties or covenants that survive consummation of the DILF, (ii) the full extent of the indemnification in any environmental indemnity provided to Lender and (iii) the obligations of Guarantor under the DILF Agreement.
- iii. Release of Lender: Borrower and Guarantor will provide a full release of Lender as to the Loan. (*Borrower strategy: No release as to any obligations and liabilities assumed by Lender at the Closing under the DILF Agreement*)

F. Representations and Warranties will need to be made by the Borrower and Guarantor:

- i. By Borrower:
 - a) Due organization, valid existence, power and authority, etc.

- b) Holds marketable record fee title, free and clean of liens and encumbrances other as disclosed per schedule (*Borrower strategy: argue to delete this as title insurance is being provided*)
- c) Not granted any liens nor sold or conveyed any part of the Property
- d) Not entered into any contract for labor or material or improvements which may subsequently result in a lien (*Borrower Strategy: Delete as Borrower will have to provide an owner's affidavit to the title company covering this*)
- e) Except as set forth on a schedule, no work performed nor materials delivered within 90 days of closing (*same as above*)
- f) No actions, lawsuits, etc.
- g) Consideration received exceeds the fair market value of the Property and Borrower obtained independent confirmation of the value of the Property
- h) The conveyance(s) under the Agreement are free and voluntary acts
- i) Borrower has not used Hazardous Materials, etc. (environmental rep). (*Borrower strategy: Make sure to qualify this representation as to anything contained/disclosed in the recent environmental report prepared for the Lender*)
- j) All rental income and other receivables collected after closing belong to the Lender and shall be paid over to the Lender upon receipt
- k) Certified rent roll, leases in full force and effect, etc.
- l) Operating statements attached are true and complete in all material respects
- m) No unpaid sums owed by Borrower under any law, license, lease, permit, utility or other service agreement related to the Property (*Borrower strategy: change to has received no notice of unpaid sums*)

- n) No notice of violations of law, zoning ordinances, etc.
 - o) Borrower has no present intent to file bankruptcy
 - ii. By Guarantor; see a, f, g, i above
 - a) Guarantor would not give representations and warranties regarding improvements performed, title, the leases, violations of law, etc.
- G. Closing Requirements
 - i. All closing documents have been executed and delivered
 - ii. All monies due under the Agreement have been paid, including all fees and expenses, accounting for all security deposits
 - iii. Reps and warranties are brought down if the Agreement is not signed simultaneous with the Closing
 - iv. Lender may require tenant estoppel certificates that do not indicate material differences from Borrower's representations under the DILF.
 - a) *Borrower Strategy: Do not make this a closing condition, but only a best or commercially reasonable efforts obligation in that sometimes it is difficult to obtain these where there have been troubles with the tenants, and in a troubled project, these are a given.*
 - v. Any and all consents required have been received by Borrower and delivered to Lender
 - vi. Lender has received a satisfactory environmental audit
 - vii. There have been no changes in physical condition of the Property
- H. The debt instruments and debt will not be terminated and/or discharged, only the Owner's liability will be limited to the mortgaged property and in certain instances there will be explicit releases.
- I. Borrower and Guarantor will waive their rights to redeem the Property post-Closing.
- J. Cash Flow. Lender will argue it is entitled to all cash flow/income generated by Center since the default (net of Lender approved

operating expenses and improvements). An accounting will be made to the Lender in terms of the costs and expenses that were or are to be paid from the Center's cash flow to insure none of it was misappropriated by the Borrower.

- i. *Borrower Strategy: Define so as to EXCLUDE any and all actual and customary expenses of operating and owning the Center (lender will attempt to qualify this as third parties unaffiliated with Borrower and/or Guarantor), insurance, taxes, tenant improvement costs, leasing costs and capital improvements. Define what expenses may be deducted from cash flow as broadly as possible.*
- ii. Lender will make sure that the Borrower is not allowed to deduct from the cash flow: depreciation, amortization, legal fees and expenses and any other management fees and monthly debt service due under the Note and TIs, leasing commissions and capital improvements that Borrower has not accounted for and for which Lender has not approved.

K. Fees: Lender will attempt to make Owner liable for as many costs and expense in connection with the DILF as possible: report costs, lender's counsels fees, transfer taxes, title premiums and other costs of transfer.

- i. *Borrower Strategy: Resist paying anything by arguing that the Lender would not get paid these expenses if it foreclosed. There is some truth to this, but there are costs associated with continuing to own the Center and many times, the expenses the Lender wants covered appear to be a better deal then continuing to own it. Bottom line, negotiate a cap or flat amount that Borrower will pay—and that is all it will pay.*

10. Deed-in-Lieu of Foreclosure Escrow: In some workouts (and dependent on a particular state's law), the Borrower is not ready to throw in the towel, but understands the Lender's need for greater certainty as to what will happen if the Borrower cannot turn things around or further defaults. In such case you may see a hybrid, where the parties enter into a Forbearance Agreement that provides for a Deed-in-lieu of foreclosure (and all related documents) for such a transfer to be escrowed with a title company and upon and an event of default by the Borrower under the Forbearance Agreement (which incorporates defaults under the Loan Documents) these documents are released from escrow to the Lender. *(Strategy for Borrower: There are issues for the Lender in terms of enforcement of such escrow arrangements in terms of clogging the equity of redemption. However, if the lender is amenable to this, then there will most likely be affirmative statements included in the Forbearance Agreement estopping Borrower from raising this*

argument. Just beware of the possible defenses/attacks the Borrower may have with such arrangements).

11. Foreclosure

A. Judicial Foreclosure

i. Advantages to Lender:

- a) Can litigate priorities over competing interests and can obtain supplementary relief to give effect to lien (i.e. judicial declaration that a lease survives foreclosure)
- b) Full remedy in one action: establish amount of deficiency, proceed on guarantees simultaneously
- c) Easier to obtain appointment of a receiver
- d) Opportunities to litigate other issues and eliminate equitable claims in a single proceeding
- e) Judicial supervision of proceedings
- f) Finality, with entry of judgment and expiration of appeal period

ii. Disadvantages to the Lender:

- a) Time Consuming—could be at least 14 months to obtain title. (*Borrower strategy: bring counterclaims and assert defenses that cannot be dismissed via summary judgment—this will likely extend this time period out considerably, giving the Borrower time to refinance, find a buyer for a short sale, possibly negotiate other alternatives with the lender in exchange for settlement, or generally turn the Center around*)
- b) Greater expense

B. Non-Judicial/Foreclosure by Advertisement

i. Advantages to Lender:

- a) Speed—in Michigan 5-6 weeks to the sale, with a 6 month redemption in most cases for commercial properties

- b) Thus, 7 ½ months from commencement to taking title
 - c) Much less expensive—avoids time consuming and costly judicial proceedings
 - d) Simplistic
- ii. Disadvantages to Lender:
- a) Obtaining a receiver is a separate ancillary action— not as easy to obtain (ancillary proceedings rule). *(Borrower strategy: Defend appointment of receiver as courts here are not predisposed to granting appointment of a receiver absent showing of harm/waste)*
 - b) No judicial supervision—*(Borrower strategy: may be able to attack validity of the bid, especially in a later action for deficiency)*
 - c) No final judgment so more reliant on title insurance
 - d) Mortgage must contain a power of sale to utilize same
 - e) No adjudication of any priority disputes, so may not appropriate if there are construction lien claimants
 - f) No judicial determination as to whether a construction lien is cut off by foreclosure unless priority of lien is clear (mortgage has been fully disbursed prior to any construction commencing or furnishing of materials).
 - g) Court may award entry of judgment of possession and expiration of appeal period.

12. When the Borrower May Prefer Foreclosure: The Borrower may prefer the Lender pursue foreclosure where the Borrower wants to buy time and maybe is not ready to throw in the towel on the Center: possibly the Center will turn around, or maybe the Borrower can get it refinanced or bring in other partners. Possibly the Borrower is not satisfied with the terms negotiated by the Lender for the DILF and would then prefer foreclosure because the Borrower can continue to negotiate with the Lender for a settlement/deed-in-lieu after the Lender has commenced the foreclosure as well as through the redemption period.

13. Filing for Bankruptcy: There are some instances where a Borrower may want to file for bankruptcy.

- A. Impact of a Bankruptcy Filing on Exercise of Remedies:
 - i. Filing of a petition in bankruptcy by the mortgagor will trigger an automatic stay under Section 362 of the Bankruptcy Code with respect to the commencement or continuation of any proceeding with respect to foreclosure of a mortgage.
 - ii. Result: there could be a 4 month to 2 year delay before stay is lifted
 - iii. *Borrower Strategy: The benefits to the borrower of filing is to get control over the cash generated by the property, stop foreclosure action and re-negotiate the mortgage loan terms.*
 - iv. The benefits to the lender: implement cash management controls and address third party matters, such as tenants and lien claimants.
- B. Is it "Single Asset Real Estate"/ SARE Debtor under Section 362(d)(d)
 - i. single commercial or multi-family project
 - ii. generated substantially all of debtor's income
 - iii. No business is conducted on the property
 - iv. No limitation on maximum amount of debt,
- C. If it is SARE, then there may be a lift of the automatic stay in a more accelerated fashion.
- D. Relief granted to creditors of SARE: stay is lifted within the later of (a) 90 days of filing or (b) 30 days after a court determination that a debtor is a "SARE" debtor UNLESS the debtor: (a) has filed a plan with a reasonable possibility of being confirmed or (b) is making monthly payments equal to non-default contract interest on the secured amount of the lender's claim.
- E. SARE—Bad Faith Filings: Findings that an effective reorganization is not possible and the filing was made in bad faith—the result, lift or dismissal of automatic stay.

- F. Fight over Cash Collateral: Debtor can use "cash collateral" of the creditor and personal property if the secured creditor is adequately protected. Rents are proceeds of real estate, so if the lender has exercised its assignment of rents prior to filing Chapter 11, then the mortgagee may be able to require segregation of rents and obtain adequate protection if the mortgagor seeks to use the rents. If it is an absolute assignment of rents as opposed to a security interest in rents, some courts have held that upon default, the mortgagor's interest in the rents are terminated and the rents are not part of the bankrupt estate.
- G. If the mortgagee is under-secured, then the secured creditor may be entitled to adequate protection for rents, however the end result will likely be that it will get a secured claim equal only to the value of the collateral (which may include the post-petition rents, net of expenses) and will be treated as an unsecured creditor for the amount of its collateral shortfall.
- H. Lifting automatic stay—dependent on issues of whether the stay harms the mortgagee and whether lifting the stay would unjustly harm the mortgagor.

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