

Dealing With Borrower Defense Strategies in Commercial Loan Default and Mortgage Foreclosure Matters – A Practical Guide for Lenders

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| Matthew D. Parrott | Partner, Litigation and Dispute Resolution, New York
p / 212.940.8842 f / 212.940.8776 e / m.parrott@kattenlaw.com |
| Andrew L. Jagoda | Partner, Real Estate, New York
p / 212.940.8520 f / 212.894.5621 e / andrew.jagoda@kattenlaw.com |
| Jeff J. Friedman | Partner, Bankruptcy and Creditors' Rights, New York
p / 212.940.7035 f / 212.940.7109 e / jeff.friedman@kattenlaw.com |

Secured Lending Litigation Issues

Matthew D. Parrott
Partner, Litigation and Dispute Resolution, New York
Katten Muchin Rosenman LLP
p / 212.940.8842 f / 212.894.5842
m.parrott@kattenlaw.com / www.kattenlaw.com

Secured Lending Litigation Issues

- New York law generally favorable to lenders in secured transactions
 - Judicial precedent
 - Statutory remedies and procedures including CPLR 3213
- The race to the courthouse
- Preemptive lawsuits and counterclaims

The Economic Crisis Defense

- General equitable power of the courts
- Attempts to enjoin or stay proceedings under CPLR 2201
 - A stay is a “drastic remedy”
 - Strochak v. Glass Paper Making Supplies Co., Inc., 239 A.D. 312, 313, 267 N.Y.S 282, 283 (1st Dep’t 1933)
 - Oritani Bank f/k/a Oritani Savings Bank v. Yonkers Waterfront, Inc., et al., Index No. 26562-08 (N.Y. Sup. May 14, 2009) (Nicolai, J)
- Force majeure clauses
 - Purpose
 - Breadth of definition vs. narrow application
 - Unfavorable market conditions generally do not qualify as force majeure events

Other Defenses and Issues

- Waiver and course of dealing arguments
 - Enforcement of no oral modification and no waiver clauses
 - The dangers of detrimental reliance
 - Prenegotiation agreements
- Election of remedies issues – RPAPL 1301
 - Completion guaranties and motions to intervene
- Enforceability of forum selection clauses
- Duty of good faith and fair dealing claims
 - Lender's exercise of rights under loan agreement
- Defenses based on alleged promises to provide future financing

Unique Issues in Condominium Foreclosure Matters

Andrew L. Jagoda
Partner, Real Estate, New York
Katten Muchin Rosenman LLP
p / 212.940.8520 f / 212.894.5621
andrew.jagoda@kattenlaw.com / www.kattenlaw.com

I. Lien Issues

- **Mechanics Liens**: In order to sell condominium units and use the sale proceeds to repay the loan, any existing mechanic's liens that encumber the condominium units must first be released.
 - Borrower's ability to extinguish liens: In a distressed situation, the borrower will likely lack the funds to bond off the lien (particularly since bonding companies are increasingly demanding liquid collateral to secure the bond).
 - Lender's ability to extinguish liens: The lender may:
 - **a)** Bond off the lien (the cost of which would be a protective advance added to the mortgage).

I. Lien Issues

- **b)** Foreclose its mortgage and extinguish the mechanic's lien, but there could be significant ramifications under local condominium statutes.
 - For example, in New York, if the lender forecloses, the lender may be required to assume the sponsor's obligations under the condominium plan, including the obligation to discharge or bond off all mechanics liens on units that the sponsor is required to construct and sell under the offering plan (see Part II below).
 - » Accordingly, as an alternative to foreclosure, the lender may want to enter into a settlement agreement with the borrower and the contractor pursuant to which the borrower will continue to complete the condominium project and the contractor will receive a portion of the sale proceeds in return for a release of its mechanic's lien.

I. Lien Issues

- **Liens for Unpaid Common Charges**: The foreclosure of a first mortgage in New York on a condominium unit will extinguish any liens for unpaid common charges filed against that unit.
 - Statutory Liens: New York Real Property Law § 339-z states that the “The board of managers, on behalf of the unit owners, shall have a lien on each unit for the unpaid common charges thereof, together with interest thereon, prior to all other liens except only ... *all sums unpaid on a first mortgage of record Upon the sale or conveyance of a unit, such unpaid common charges shall be paid out of the sale proceeds or by the grantee.*”

I. Lien Issues

- The New York Court of Appeals has held that § 339-z does not require a lender to use the proceeds from a foreclosure sale to pay the holder of a statutory lien for common charges because (i) § 339-z specifically states that recorded first mortgages have priority over such liens, and (ii) only proceeds from *voluntary* unit sales must be used to pay down unpaid common charges.^[1]
 - Note: The lender (or foreclosure sale purchaser) will be responsible for paying common charges that are assessed against the unsold units following foreclosure and any liens imposed upon the unsold units if such common charges are not paid when due.
 - Commercial Condominiums: § 339-z also provides that the declaration of condominium for an exclusively non-residential condominium may provide that the statutory lien for common charges will be superior to any mortgage liens of record.
- Other Liens: The New York Supreme Court has held that the foreclosure of a first mortgage on a condominium unit extinguishes a lien for unpaid common charges filed by a homeowners association against that unit.^[2]

^[1] Bankers Trust Company v. Board of Managers of the Park 900 Condominium, 600 N.Y.S.2d 191 (1993).

^[2] Crossland Savings Bank, FSB v. Saffer, 153 Misc. 2d 287 (Sup. Ct., 1992).

II. Consequences of Foreclosure or Default in New York

- Newly-constructed condominiums in New York are governed by:
 - § 352-e et. seq. of the New York Business Law (the “Martin Act”),
 - Article 9-B of the New York Real Property Law, § 339-d et. seq. (the “Condominium Act”), and
 - Part 20 of Title 13 NYCRR, entitled Regulations Governing Newly Constructed, Vacant or Non-Residential Condominiums (the “Regulations”), which are promulgated by the New York Department of Law, and which set forth the requirements for the condominium offering plan or offering statement required by the Martin Act.
- The government agency that is the primary enforcement agency is the Real Estate Finance Bureau of the New York Department of Law, which is the New York State agency headed by the New York State Attorney General.
- Three major consequences that the lender will have to deal with after the foreclosure of a condominium project in New York:

II. Consequences of Foreclosure or Default in New York

1) The lender will have to ***amend the condominium offering plan.***

- § 20.5 of the Regulations requires that an amendment be made to the condominium offering plan after any material change in order to disclose the details of the material change and update the status of the condominium offering plan.
 - If there is a change of sponsor (as discussed below), the amendment must include information on the new sponsor required by §§ 20.2(c-d) of the Regulations, including, except where exempted under the Regulations:
 - Signed broker-dealer statements (M-10 forms) for the (i) sponsor's selling agents, and (ii) sponsoring entity, including all officers, directors, partners or principals who are dealers for purposes of § 359-e of the New York General Business Law.
 - Signed salespersons' statements (M-2 forms) for the sponsor's employees who act as salesperson(s).

II. Consequences of Foreclosure or Default in New York

- Signed registrant information forms (RI-1 forms) disclosing prior convictions, judgments, administrative actions, bankruptcy, and business affiliation for all principals of the sponsor.
- Net worth and real estate business history affidavits.
- A statistical information card from the Department of Law.
- Checks for the balance (if any) of filing fees pursuant to the Martin Act.
- If required by the Department of Law, new certifications by the new sponsor, its principals, its architect or engineer, and its experts on the adequacy of the budget and common charges payable by commercial unit owners.
- Note: If the Department of Law determines that the new sponsor will be unable to satisfy the sponsor's obligations, pending purchasers will likely be granted a right of rescission (see below).

II. Consequences of Foreclosure or Default in New York

2) The lender (or other buyer at the foreclosure sale) will become the ***new sponsor*** of the condominium under the Regulations.

- § 20.1(c) of the Regulations defines a “sponsor” as “any person ... or other entity which makes or takes part in a public offering or sale in or from the State of New York of securities consisting primarily of shares or participation interests or investments in real estate including condominium units.”
 - Sponsor’s Relationship with the Board of Managers: Although the sponsor may exercise a veto power over the board of manager’s decisions regarding certain expenses, such veto power will terminate no later than five year after the closing of the first unit or whenever the unsold units constitute less than 25% of the common interest (pursuant to § 20.3(u) of the Regulations).
 - Note: The sponsor should make sure that the condominium offering plan or bylaws exempt sponsor-owned units from any right of first refusal with respect to the sale or lease of a unit that the board of managers may have under the condominium declaration and bylaws.

II. Consequences of Foreclosure or Default in New York

- § 20.3(t) and § 20.5(c) of the Regulations specify the following sponsor obligations, which continue until all units have been sold:
 - Pay for the authorized and proper work involved in the construction and sale of the condominium that the sponsor is obligated to complete under the offering plan and (as mentioned above) *cause all mechanics liens with respect to such construction to be promptly discharged or bonded.*
 - Pay all common charges, special assessments and real estate taxes with respect to unsold units.
 - Make certain disclosures regarding the sponsor's financial resources, background, experience, and principals (and felony convictions) (see the list of required documentation in Part II, § 1 above);
 - Procure fire and casualty insurance.

II. Consequences of Foreclosure or Default in New York

- File an amendment to extend the term of the offering plan once every 12 months.
 - This amendment must disclose all material changes, including an updated budget, material expense decreases or increases, financial statements, and the sponsor's then-current control over the board of managers.
 - » If the sponsor owns more than 10% of the units, the amendment must also disclose (i) the aggregate monthly common charge payments and real estate taxes payable for sponsor-owned units, (ii) financial obligations to the condominium which will become due within 12 months, (iii) a list of all unsold units subject to mortgages, and detailed information on those mortgage loans, (iv) how the aforementioned obligations will be funded, (v) sponsor's then-current financial obligations, and (vi) other condominiums, cooperatives and homeowners associations owned by the sponsor.

II. Consequences of Foreclosure or Default in New York

- Prior to closing the first unit, obtain a permanent certificate of occupancy for the building or a temporary certificate of occupancy for the unit to be closed (in addition, the sponsor must obtain a permanent certificate of occupancy within a projected timetable after the closing of the first unit).
- If the first closing takes place before a permanent certificate of occupancy is issued, maintain all deposits under purchaser contracts and funds from purchasers in a special escrow account (or provide a letter of credit, surety bond, or other collateral acceptable to the Department of Law).

II. Consequences of Foreclosure or Default in New York

3) If there are pending sales of condominium units, the purchasers may be granted a *right of rescission*.

- According to the Department of Law, after foreclosure, the new sponsor (the lender or the foreclosure sale purchaser) may be required by the Department of Law to grant a right of rescission to purchasers who have signed outstanding contracts to purchase condominium units, particularly if the Department of Law determines that the new sponsor will not be able to meet its obligations under the offering plan.
 - If there are no pending or closed unit sales, the new sponsor may elect to abandon the project (and, for example, convert the property into a rental) as long as it files a Notification to the Attorney General of the State of New York of Abandonment of Offering (form “RS-3”) pursuant to § 20.1(l).

II. Consequences of Foreclosure or Default in New York

- Note: Under § 20.3(g), the sponsor must amend the budget for the first year of condominium operation if the actual or anticipated date of commencement of condominium operation is delayed more than six months from the budget year projected in the offering plan. If the revised projections exceed the original projections by 25% or more, the sponsor must offer all purchasers a right of rescission, and return any deposit or down payment.
- Potential consequences upon the occurrence of an Event of Default:
 - The Real Estate Finance Bureau has also indicated that if there simply exists an “Event of Default” under the mortgage loan, a material change may have occurred even if the lender has not yet taken any action.
 - Whether any Event of Default will be deemed to be a material change will depend on the type of event and/or the lender’s response to that event.

Bankruptcy Basics for Commercial Lenders

Jeff J. Friedman
Partner, Bankruptcy and Creditors' Rights, New York
Katten Muchin Rosenman LLP
p / 212.940.7035 f / 212.940.7109
jeff.friedman@kattenlaw.com / www.kattenlaw.com

Automatic Stay in Bankruptcy

- Goes into effect upon the filing of a voluntary or involuntary bankruptcy petition (a breathing spell)
- Generally stays all litigation against the debtor
- Generally stays all efforts to enforce judgments or collect pre-bankruptcy debts or to exercise any control over the debtor's property
 - Foreclosure is stayed
 - Even giving notices that are a legal pre-requisite to enforcement are stayed
 - Setoff is stayed
 - Most efforts to perfect liens are stayed

Automatic Stay in Bankruptcy

- Relief from the stay
 - For cause, including a lack of “**adequate protection**”
 - With respect to an act against the debtor’s property (e.g., foreclosure), if the property is not necessary to an effective reorganization (reasonably in prospect) and the debtor has no equity in the property
 - Multiple bankruptcy filings affecting real property

Basics of Chapter 7 and Chapter 11

- Chapter 7 – Mandatory appointment of a **trustee** who replaces debtor's management and controls the estate. Trustee marshals the assets and converts them to cash for distribution to creditors in accordance with the priorities contained in the Bankruptcy Code.
- Chapter 11 – Management presumed to stay in control and possession of the debtor's property (**debtor-in-possession or DIP**). Trustee can be appointed in chapter 11 for fraud, gross mismanagement or if in the best interests of creditors.
- Can reorganize or liquidate in chapter 11. May choose chapter 11 to liquidate because existing management is likely to realize greater value for the assets; also less of a "fire sale" mentality than in chapter 7.

Basics of Chapter 7 and Chapter 11

- Chapters 7 and 11 – Collect all of the claims and assets in one court (the bankruptcy court). Prepetition claims generally cannot be paid except pursuant to distributions from the liquidation in a chapter 7 or pursuant to a chapter 11 “plan” of reorganization or liquidation.
- In chapter 7 all claims must be asserted via proofs of claim filed by creditors; in chapter 11 claims can also be allowed if the debtor admits the debt is owed in its schedule of liabilities by listing the amount of the debt as liquidated, non-contingent and undisputed.
- Chapter 7 trustee can, but rarely does, operate the business for a short period if helpful to the liquidation.
- Chapter 11 - usually try to maintain business operations to keep going concern value if possible.

Basics of Chapter 7 and Chapter 11

- Chapters 7 or 11 – Can only use, sell or lease property of the estate in the ordinary course of business without specific court approval. Ordinary course of business may vary depending on the nature of the business. Rough rule of thumb is that transactions that would require the equivalent of board approval outside of bankruptcy are outside the ordinary course of business.
- Chapters 7 or 11 – Can reject **executory contracts** or **unexpired leases** that are burdensome to the estate. Claims arising from rejection are treated as breach of contract prepetition claims. Can also assume executory contracts or assume and assign to 3rd parties by curing any curable defaults and providing adequate assurance of future performance.
 - Non-residential real property leases have to be performed by the debtor with respect to obligations that come due during the post-petition period.
 - Other contracts, if performed by the debtor during the post-petition period must generally also be performed by the non-debtor party to the contract (even if there are prepetition arrearages).

Basics of Chapter 7 and Chapter 11

- Chapter 11 usually begins with a period for attempting to stabilize the business.
 - First day relief often including **use of cash collateral or “DIP” financing**; payment of prepetition wages; maintaining cash management systems; and dealing with utilities. Rents that are cash collateral can be used by the debtor with court permission (or lender’s consent) by providing adequate protection for the potential diminution in the value of the lender’s overall collateral position.
 - Early rejection of burdensome contracts and leases
 - Shut down of non-viable divisions; cost cutting to stop cash losses
 - Trying to get to operational break-even or better

Basics of Chapter 7 and Chapter 11

- Stabilization is followed by formulation of a business plan and negotiations with major creditor constituencies over a plan of reorganization.
 - Very often a sale of the business or key assets is the goal of the debtor and prepetition lender.
 - Standalone reorganizations are becoming much more rare.
 - Chapter 11 debtor has 120 days during which it has the exclusive right to propose a plan – can be shortened or lengthened for “cause”. 18 month exclusivity maximum. If plan is timely filed, 60 extra days of exclusivity are provided in which the debtor can try to solicit votes and seek confirmation of its plan.

Basics of Chapter 7 and Chapter 11

- Chapter 11 plan confirmation is the goal
 - Effectively a proposed contract with creditors to replace all the pre-bankruptcy obligations.
 - Plan classifies creditors by type (secured, unsecured, subordinated, equity). Creditors whose contract or state law rights are **impaired** by the plan vote as classes to accept or reject the plan. Creditors accept a plan if a majority in number and 2/3 in amount of claims actually voting, vote to accept. Equity classes accept if 2/3 of the interests in the class actually voting, vote to accept.
 - If the plan is confirmed, **all** creditors and equity holders are bound whether or not they voted and irrespective of how they voted.

Basics of Chapter 7 and Chapter 11

- If a class rejects the plan, the plan proponent may nevertheless be able to confirm the chapter 11 plan if it can satisfy the “cramdown” standards with respect to the rejecting class. Compliance with the **absolute priority rule** and no “unfair” discrimination. These tests vary by the type of class (secured, unsecured, equity).
- Other confirmation requirements include the requirement that every impaired creditor get more under the plan than it would get in a chapter 7 liquidation (“best interests of creditors” test), that the plan’s implementation be feasible and that if there is a class of creditors impaired by the plan, at least one such class must vote affirmatively to accept the plan (i.e., cannot cramdown every impaired class).

Basics of Chapter 7 and Chapter 11

- Trustee or DIP can retain professionals with court approval (attorneys, accountants, financial advisors, auctioneers, turnaround managers, etc.). Professional fees, like other obligations incurred by the debtor during the bankruptcy case, are considered “**administrative expense**” **claims** and are entitled to be paid in full before the payment of pre-petition claims.
- Chapter 11 – If sufficient interest, a **committee of unsecured creditors** will be appointed to serve as a “watchdog,” a negotiating partner and a representative of unsecured creditors generally. Committee can also hire professionals at the expense of the debtor’s estate.
- Appointment of bankruptcy trustees and creditors’ committees are made by the United States Trustee (not to be confused with a bankruptcy trustee for a specific debtor).

Basics of Chapter 7 and Chapter 11

- Chapter 7 – Trustee pays claims in a priority order established in the Bankruptcy Code. Allowed claims having a special priority are paid first, followed by payments to holders of allowed general unsecured claims and ultimately to equity holders if creditors are paid in full together with post-petition interest. Where debtor is not an individual, the major, but not only, priority categories are (in order):
 - administrative expenses of the bankruptcy case, including professional fees and trustee commissions
 - gap claims [involuntary petitions]
 - 180-day wage priority claims up to \$10,950 per person
 - 180-day employee benefit plan priority claims (up to unused wage priority)
 - most tax claims (and penalties designed to compensate for pecuniary loss)

Basics of Chapter 7 and Chapter 11

- Chapter 11 – As a confirmation requirement the plan must provide for payment in full, in cash, of claims having a priority above general unsecured claims (individual claimants can voluntarily agree to a different treatment). Classes of impaired creditors can vote to take something less than absolute priority rule might provide (most often to buy peace and avoid the delays and costs of plan or other litigation).
- **Discharge** of remaining unpaid claims is the ultimate goal in a bankruptcy. No discharge is available in Chapter 7 except for individuals because a liquidating entity will distribute all of its assets and does not need a discharge. Theoretically, no discharge is available in chapter 11 for a liquidating entity either, although many plans provide for a discharge even though assets have been sold.
- Discharge occurs in chapter 7 for an individual after the date for objecting to discharge passes. Creditors who have been defrauded or have other grounds can object to the discharge of their particular claims and ask the bankruptcy court to declare them non-dischargeable.
- Discharge occurs in chapter 11 on the effective date of a confirmed plan.

Single Asset Real Estate Cases

- “Single Asset Real Estate” is real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of the debtor and on which no substantial business is being conducted by the debtor other than the business of operating the real property and activities incidental.
- Special stay relief provision – the court must grant stay relief with respect to a stay of an act against single asset real estate by a creditor whose claim is secured by an interest in the real estate unless within 90 days of the bankruptcy filing (a period that can be extended for cause by an order entered within the 90-day period) or 30 days after the court determines that the debtor is a single asset real estate debtor.
 - The debtor has filed a plan that has a reasonable possibility of being confirmed with a reasonable time, **or**
 - The debtor has commenced making monthly interest payments at the non-default rate to the secured creditor. (The debtor, in its sole discretion, can use rent/income cash collateral generated by the real estate to make these interest payments without court approval or lender consent).

Single Asset Real Estate Cases

- Hard to confirm a chapter 11 plan over secured lender's objection because –
 - Undersecured creditor's claim in a bankruptcy case consists of two claims – a secured claim equal to the value of the collateral and an unsecured claim equal to the deficiency.
 - Secured portion and the unsecured deficiency claim have to be in separate classes, but the deficiency claim generally must be in the class with other general unsecured creditors.
 - 800-pound gorilla may have the votes to block acceptance of only impaired classes and thwart the debtor's ability to satisfy the "one accepting impaired class" requirement for confirmation.
 - Courts are sensitive to creative classification as an attempt to gerrymander the vote and obtain an accepting class. Note that the votes of insiders are not counted for purposes of determining whether there is one accepting impaired class.