

Commercial Real Estate Portfolio and CMBS Loan Workouts: Forbearance, Foreclosure and Bankruptcy

Protecting Lender and Borrower Interests When Dealing With Distressed Loans

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Real Estate Loans in Trouble: Understanding Securitized Lending in Default Situations

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A Broader PerspectiveSM

Differences in CMBS Lending vs. Portfolio or Balance Sheet Lending

- Basic Differences from Balance Sheet Lending
- Significance/Impact on Commercial Real Estate Finance
- Structure of Standard CMBS Loan
- Parties and Relationships/Roles and Motivations
- Special Servicer

Overview of Securitized Loan Originations

- Making the Loan
 - Originator Underwrites and Closes Loan in Own Name
 - Loan Usually “Table Funded” By Warehouse Lender/Securities Issuer
 - Warehouse Lender and “B” Piece Buyers Play Key Roles In Underwriting
- Immediate Loan Sale
 - Along with Closing Documents, the Loan is Assigned to the Warehouse Lender/Securitized Issuer
 - Importance of Representations and Warranties by Loan Originator Relating to Standardized Documents

Overview of Securitization Process

- Key Players
 - Securitization Trust as Holder of Pooled Loans
 - Investors
 - Tranche Investors – “A” Piece and “B” Piece Investors
 - Servicers – Master and Special Servicers
 - “B” Piece Investor Often in Role as Special Servicer
- Purpose of Trust Structure
 - Use of REMIC Trust Structure for Tax Benefits
 - Legal Limitations of REMIC Structure for Individual Loans

Current Snapshot

- Matured Loans That Are Delinquent
 - Has been increasing each month during 2015
 - First wave of the deals underwritten under deteriorating standards from 2005 to 2007
 - Matured and Delinquent
 - Consistently between 7-10% of matured loans
 - Matured and Current
 - Consistently between 3-6%
- Performance of Sectors
 - Multifamily and Retail are underperforming with only about 75% being paid off by maturity
 - Office, Mixed-Use, Industrial and Hotel are paying off by maturity at a rate of approximately 95%

Role of Servicers

- Pooling and Servicing Agreement (PSA)
 - Sets the Operational and Control Issues
 - Controls the Actions of the Investors and the Servicers
- Master Servicer
 - Manages Basic Loan Administration
 - Limited Authority to Make Decisions
 - “B” Piece Owner is initial “controlling investor”
- Special Servicer
 - Manages Unique Decisions and Default Situations
 - More Authority than Master Servicer, But Still Limited By PSA Terms and REMIC laws
 - “A” Piece Owner is successor “controlling investor”

Master vs. Special Servicers

- Role of Master Servicers
 - Oversees Loan Payments, Application of Reserves, Basic Lease Approvals Within Terms of the Loan Documents
 - Not Authorized to Make Major Lease Decisions or Changes in Reserve Provisions
 - Not Authorized to Work Through Default Situations
- Role of Special Servicers
 - Review Loan Modifications, Post Default Issues, Post Maturity Problems
 - Role of the Controlling Investor Class (Usually “A” Piece Owner)
 - Tension between investor classes in default situation

CMBS – Lender Remedies

- Default and Acceleration
- Forbearance
- Foreclosure
- Receivership
- Bankruptcy

Forbearance Agreement

- Reasons for Using This Agreement
- Maintain Relationship as Part of Exit Strategy
- Basic Elements
- Acknowledge Defaults
- Confirm Notice and Cure Periods Have Expired
- Choice – (i) Initiate and Then Postpone Remedies, or (ii) Forbear From Both Initiation and Exercise of Remedies
- Obtain Key Waivers Not Available In Other Contexts (i.e., One-Action, Anti-Deficiency and Lift Stay)
- Confirm Source and Purpose of Payments by Borrower or Guarantor as “Voluntary Payments”
- Restructure Business Terms to Reach Exit Strategy

Roles of Parties During Exercise of Remedies

- Proper Parties

- Trustee for Trust is technically the Proper Party in any Litigation and/or Workout Because Trust Holds the Loans
- Servicer is Agent Acting for the Trust and also is the “active” Party for Purposes of Proceeding with Either Litigation or Workout Remedies
- Originator Typically is Not a Party in Any Capacity

- Obstacles/Challenges

- Must Locate All Assignments to Trace Ownership of the Loan by the Trust
- Servicers Bound by PSA, But PSA is Not a Public Document

Immediate Actions

- Default/Acceleration Notices
 - Use Of Pre-Workout Letters
 - Establish Basis Of Disputes – Describe Disputes And Defaults
 - Sets Boundaries For Discussions – No Obligations On Lender, No Waiver Or Estoppel, Confidentiality, Right To Terminate And Pursue Remedies, Ease Path To Remedies - i.e., Receivership
- Enforceability of Pre-Workout Letters
 - Extent of Confidentiality/Evidentiary Protections
 - Specific Remedies/Attorneys' Fees Provisions

Note on Immediate Actions

- Practice Tip
 - Very little litigation on the enforceability of Pre-Workout Letters
 - Try to take full advantage of existing state and federal law on settlement discussions
 - Err on the side of more detail and more explanation of the terms and boundaries

Immediate Actions (Part II)

- Obligations of the Property Manager
 - Decision on Whether to Terminate Or Continue Current Property Manager
 - Distinction Between Insider Manager vs. Third Party Manager
- Lockboxes
 - Provide Notice of any Change Application Of Funds (i.e., Hold Excess Proceeds, Apply for Specific Purpose, etc.)
 - If There is a Springing Lockbox, Then Notice of Any Triggering Event, if applicable, Shall be Given;
 - “ARD” Situations for Securitized Loans

Immediate Actions (Part III)

- Staged Response
 - First, Default/Notice Letter – this document puts the game in motion and often is required in syndicated or participated loans
 - Practice tip: Beware of the need for co-lender approvals
 - Next, Pre-Workout Letter – this document sets the ground rules and establishes the protections for the lender to have open discussions
 - These are more negotiable when the lender is not a loan servicer
 - Finally, Foreclosure or Workout
 - Workout = Forbearance Agreement or Modification Agreement
 - Foreclosure = Determination That There is No Alternative for a Workout

Use of Special Purpose Entities in Foreclosures

- Reasons for Forming SPE in Foreclosure/Workout Remedies
 - Isolate Troubled Asset from the Rest of the Loan Pool
- Who Controls the SPE
 - Special Servicer Usually is the Sole Member and Manager of SPE in Order to Orchestrate Remedies
- Problems
 - Issues Relating to Transfer of all Tranche Interests into SPE
 - Partial Note Foreclosure Issues
 - May Be Limitations in PSA or Under Applicable Law

Enforcement Options

- Receivership
 - Ex Parte vs. Motion for Appointment
 - Practical Considerations
- Writs of Attachment
 - Tool To Use On Guarantors
- Remedies Against Personal Property Collateral
- Judicial vs. Non-Judicial Foreclosure
 - One Action and Anti-Deficiency Considerations
 - Optional Use of Either Remedy; “Dual Tracking”
 - Timing Considerations

Enforcement Options (Part II)

- Bad Boy Carve-Out Guaranties
 - Enforced by Courts for Damages or Full Recourse
 - Not Prohibited as Liquidated Damages or Penalty Provisions
 - Specificity of Provisions Affects Enforceability
- Springing Recourse Guaranties
 - BK Filing, SPE Violations, Additional Debt and Unpermitted Transfers Can Be Recourse Triggers
 - Practice Tip: Misapplication of Funds Can Apply to Transfers of Rents, Proceeds, Accounts and Receivables
 - Beware of *Cherryland* Issues

Enforcement Options (Part III)

- Expansion Of Waste Remedies
 - Failure to Maintain or Repair Property with Rents or Other Revenues
 - Failure to Pay Taxes or Insurance Premiums
 - Failure to Make Ground Lease Payments
- Material Adverse Change (or MAC) Provisions
 - Limited Case Law in the Loan Context (most cases come out of the insurance context)
 - Subjective vs. Objective Standards
 - Practice Tip: Enforceability is often tied to objective criteria for triggering a MAC provision – Very Little Guidance With Regard to Real Estate Secured Loans, But Judicial Bias Against Employing a MAC Provision as Grounds for a Property Forfeiture
 - Trigger Default vs. Trigger Additional Lender Rights

Alternative Transaction Options

- Alternatives to Foreclosure
 - Deed in Lieu of Foreclosure or Note Sale
 - Title Subject to Competing Liens and Other Defects
- Consensual Foreclosure
 - Permits a Lender to “Clean Up” Title, And Can Speed Up the Process
 - Receiver Sale – Compare with Risks for Non-Consensual Receiver Sales
- Consensual Bankruptcy
 - Risk Of Trustee Or Judicial Interference

Pre-Foreclosure Note Sale Issues

- Note Sales
 - Previously Limited Market; Uncertain Pricing
 - More sophisticated investors in the market now, so more note sales at higher prices
 - Practice Tip – If the borrower is in bankruptcy, then:
 - Note sale is possible without court approval
 - Property sale requires court approval
 - Note that a competing property sale offer can be the basis for a lender's competing plan and can lead to a 363 sale

Post-Foreclosure REO Sale Issues

- Advantages Over Note Sales
 - Servicers Usually Not Authorized to Sell Notes Under PSA
 - Title is Cleaned Up for Purchaser After Foreclosure
 - Bankruptcy Risk Eliminated Following Completion of Foreclosure
- Obstacles
 - Increasing Reluctance to Take REO on Books
 - Long Delays for Buyers and Sellers of Underlying Property Assets

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Commercial Real Estate Portfolio and CMBS Loan Workouts

Alternatives to Foreclosure

May 28, 2015

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Alternatives to Foreclosure

- Preliminary issues
 - Step 1: Before commencing any discussion, obtain a Pre-Negotiation Agreement (PNA)
 - A PNA is designed to:
 - Protect the lender and its representatives
 - Manage the borrower's expectations at the start of discussions concerning the modification or extension of a loan

Alternatives to Foreclosure

- Preliminary issues (continued)
 - Pre-Negotiation Agreements (continued)
 - There are five basic provisions that the PNA should address:
 - No final agreement until reduced to a final, signed document
 - All discussions and writings are confidential and inadmissible in court
 - The borrower and all guarantors affirm the loan document obligations and acknowledge that neither party is waiving their rights under the loan documents
 - Current borrower representatives should be identified and the PNA should be signed by the borrower and all guarantors
 - Costs to be borne by the borrower

Alternatives to Foreclosure

- Preliminary issues (continued)
 - Pre-Negotiation Agreements (continued)
 - Additional PNA terms:
 - Other terms may be included, such as:
 - Release of claims against Lender
 - Certain representations and warranties
 - Interim forbearance terms
 - Ability to end negotiations at any time

Alternatives to Foreclosure

- Preliminary issues (continued)
 - Step 2: Determining the underlying causes of default
 - The lender and borrower must agree on the cause
 - Is the default due to factors beyond the borrower's control or due to the borrowers?
 - If beyond the borrower's control, it may be worthwhile to work with the borrower
 - If fault lies with the borrower, leaving the borrower in control may not be an option

Alternatives to Foreclosure

- Preliminary issues (continued)
 - Step 3: Assessing the collateral
 - Evaluating the physical condition
 - Obtaining an appraisal/broker's opinion of value (BOV)
 - Is the loan over secured or under secured?
 - Under secured – realistic expectation of recovery if exercise remedies
 - Over secured – increases risk of a successful reorganization plan in bankruptcy

Alternatives to Foreclosure

- Preliminary issues (continued)
 - Step 4: Evaluating the problems associated with the exercise of remedies
 - Mortgagee-in-possession
 - Mechanic's, judgment, tax or other liens
 - Feasibility of operation by the lender
 - Environmental issues
 - Likelihood of success of modification

Alternatives to Foreclosure

- Preliminary issues (continued)
 - Step 5: Engaging the borrower to look at the issue from the lender's perspective
 - Motivating the borrower to be part of the solution
 - Encouraging the borrower to develop a proposal based upon:
 - Ability to continue to pay debt service
 - Ability to fund reserves for tenant improvements, leasing commissions and maintenance
 - Ability to satisfy of a portion of the outstanding principal
 - Likelihood of payment of the loan balance at the existing or extended maturity date

Alternatives to Foreclosure

- Preliminary issues (continued)
 - Step 5: Engaging the borrower to look at the issue from the lender's perspective (continued)
 - The borrower should provide:
 - Estimate of current market value
 - Updated operating statement, rent roll and financial statements
 - Leasing and management plan, including analysis of potential operational savings (without impairing revenues)
 - Special considerations – loss of major tenant or tenant bankruptcy

Alternatives to Foreclosure

- Preliminary issues (continued)
 - Step 5: Engaging the borrower to look at the issue from the lender's perspective (continued)
 - What won't work:
 - Cessation of payments by the borrower, especially where the property is generating positive cash flow
 - Lack of communication/response from the borrower
 - Unsupported requests for a write-down of the outstanding principal balance
 - Unrealistic expectations

Alternatives to Foreclosure

- Deeds-In-Lieu of Foreclosure
 - Deed-in-lieu of foreclosure is a conveyance of property from borrower/owner to lender in satisfaction of debt obligation
 - Possible to convey by either quit-claim, special warranty or general warranty deed
 - Obtain deed-in-lieu title commitment
 - Cannot be unilateral: mortgagee/beneficiary must “accept” deed
 - Possible to keep lien on property (i.e., non-merger) if properly documented
 - Acquisition of title by mortgagee generally “merges” lien interest into fee interest, unless clearly intended otherwise
 - Lender can maintain recorded lien or use a subsidiary of lender to take title; can then foreclosure junior interests through strict foreclosure

Alternatives to Foreclosure

- Deeds-In-Lieu (continued)
 - Pros of Deeds-in-Lieu
 - Reduces time and expense of foreclosure proceeding
 - Trustee's sale judicial foreclosure and forfeiture proceedings are considerably longer
 - Particularly attractive to lender if non-recourse obligation or if any deficiency would be uncollectible
 - Accelerates possession and control of property by lender and fosters smoother transition of property'
 - Less chance for abandonment of property
 - Allows resolution of documentation problems (e.g., legal description problems, defective perfection) as well as release of potential claims

Alternatives to Foreclosure

- Deeds-In-Lieu (continued)
 - Cons of Deeds-in-Lieu
 - Since simple conveyance (not foreclosure), lender only acquires that interest in property held by borrower
 - Subject to all consensual liens, leases, title defects, mechanic's liens, tax liens, easements, etc.

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modifications
 - Forbearance Agreements
 - Bring the loan back to performing status
 - Usually accomplished by modification
 - Benefits to the lender
 - Acknowledgement of loan balance
 - Acknowledgement of existing defaults
 - Express, written forbearance request
 - Established end date for forbearance period
 - Allows time for amendment to loan documents
 - Acknowledgment of enforceability/priority
 - Release of claims/waiver of defenses

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modifications (cont.)
 - Forbearance Agreements (continued)
 - Benefits to the borrower
 - Breathing room to assess ability to service debt
 - Limited duration
 - May allow continued advances under loan document

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modifications (cont.)
 - Loan Modifications
 - Extending the maturity date
 - Maturity Default
 - Extending the maturity date may be a desirable option so long as the borrower continues to make monthly interest payments
 - Additional terms for consideration:
 - Increased interest rate (immediate or delayed)
 - Payment of fees/points
 - Additional security

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modifications (cont.)
 - Loan Modifications (continued)
 - Extending the maturity date (continued)
 - Payment default
 - Interest-only loans/interest-only periods
 - Default in scheduled monthly principal and interest payments
 - Extension of the maturity date may not be the best solution because the issue is likely cash-flow driven – other solutions, like short-term reduction in payments, may be more desirable

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modifications (cont.)
 - Loan Modifications (continued)
 - Changing or removing extension options
 - The borrower's default may have eliminated any extension terms originally granted in the loan documents
 - The completion by borrower of benchmarks upon which extension options may be reinstated
 - Additional options may be added to allow for future extensions upon the payment of a pre-determined fee

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modification (cont)
 - Loan Modifications (continued)
 - Adjusting the loan amount
 - Reliable valuation and income projections required
 - Lenders are resistant to write down the principal balance
 - Bifurcating the loan – A/B Note structures

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modification (cont)
 - Loan Modifications (continued)
 - Obligatory v. optional advances
 - Full or partial loss of priority
 - Effect on existing intercreditor agreements and junior liens
 - Equitable subrogation considerations

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modification (cont)
 - Loan Modifications (continued)
 - Interest rate adjustments/bifurcation of the interest rate
 - Permanent or short-term
 - Adjustable or fixed
 - Increased principal payments
 - Payment of fees/points
 - Additional security

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modification (cont)
 - Loan Modifications (continued)
 - Modifying payment provisions
 - Reduction of monthly debt payments or complete forbearance
 - Most useful where the project is currently generating insufficient cash flow, but improvement is anticipated
 - Reduced payment terms should operate for a limited period of time, the original (or better) loan terms should then be reinstated

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modification (cont)
 - Loan Modifications (continued)
 - Modifying payment provisions (continued)
 - The lender can offset reduced payments by:
 - Providing for a proportionate increase in the interest rate at the end of the reduced payment period
 - Negatively amortize the loan on a monthly basis in the amount by which the original payments exceed the reduced payments
 - Requiring additional security
 - Taking an equity position in the property

Alternatives to Foreclosure

- Forbearance Agreements and Loan Modification (cont)
 - Loan Modifications (continued)
 - Changing, adding or releasing collateral securing the loan
 - Adding new guarantors
 - Requiring guarantors to provide collateral to secure their obligations
 - Releasing of portions of the collateral (pad sites) for sale to tenants and using the proceeds to pay down the loan
 - Additional collateral – if available

Alternatives to Foreclosure

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Single Asset Real Estate Cases in Bankruptcy

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Part I: What Is A Single Asset Real Estate (SARE) Bankruptcy Case?

- 3 Elements
 - Real property that constitutes a single property or project
 - Generates substantially all of debtor's income
 - Debtor Not Involved in Other Substantial Business
- An entity whose sole purpose is to operate real estate with monies generated by the real estate

Part II: Threshold Issues

- Dismissal for Bad Faith Filing
- Cash Collateral and Adequate Protection
- Receiver Issues

Dismissal for Bad Faith Filing

- Filed shortly after the commencement of the case
- Dismissal for “Cause”
- Subjective vs. Objective Test
 - “New Debtor Syndrome”
 - Few unsecured creditors, few employees
 - Two-Party Dispute with Secured Creditor
 - Ability to Reorganize

Cash Collateral and Adequate Protection

- Security Interest in Rents
 - Perfection: recordation vs. additional acts
 - Absolute Assignments
- Adequate Protection
 - Cash Payments
 - Replacement Lien
 - “Indubitable Equivalent”
- Allocation of Adequate Protection Payments to Secured Creditor’s Claim

Receiver Issues

- Rule: Receiver Must Turnover Property to Debtor Upon Filing of Bankruptcy
- Exception: Receiver May Retain if Interests of Creditors Better Served
 - Mismanagement of Debtor?
 - Sufficient Income to Fund Reorganization?
 - Avoidance Issues?

Part III: Stay Relief

- 362(d)(3): Special SARE Stay Relief
- 362(d)(1) and (2): Generally Applicable Stay Relief Provisions

Stay Relief: 362(d)(3)- Special SARE Provisions

- Within 90 days of filing bankruptcy, the debtor must either:
 - Commence making monthly payments based on the contract rate, or
 - File a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable amount of time

Generally Applicable Stay Relief Provisions: 362(d)(1) and (2)

- 362(d)(1): stay relief for “Cause”
 - Lack of adequate protection
 - Bad faith
- 362(d)(2)
 - Lack of Equity
 - Property is Necessary for an Effective Reorganization

Part IV: Reorganization Issues

- Impairment of Claims
- Reinstatement of Loan Terms
- Cramdown and the 1111(b) Election
- Absolute Priority Rule and New Value Exception
- Feasibility

Impairment

- A Creditor is “Impaired” unless a plan leaves the creditor’s legal, equitable and contractual rights unaltered
- Artificial Impairment (insider claims, priority claims)
- Implications
 - Right to Vote
 - Requirement of Impaired Accepting Class

Reinstatement

- Reinstatement of a Defaulted Loan
 - Original Terms of the Loan
 - Interest Rate
- Requirement to Cure Default
 - Cross-default provisions
 - Must be Cured: Legal fees, foreclosure notice fees, court costs, but not late fees
 - Need Not be Cured: Financial covenants

Cramdown and 1111(b)

- Cramdown: confirming a plan over the objections of an impaired class of creditors
- One Secured Creditor, Two Classes of Claims
 - Secured Claim: payments equal to present value of collateral
 - Unsecured Claim: payments equal to claim, or nothing to junior class (equity)
- 1111(b): Secured Creditor Elects to Have Claim Treated as Secured and Retain Its Lien

Absolute Priority Rule and New Value Exception

- Rule: unsecured claims must be paid in full or junior claims (equity holders) receive nothing
- Exception: equity holders may retain interests without paying unsecured claims in full if they contribute new value that is
 - New
 - Substantial
 - Money or Money's Worth
 - Necessary for a Successful Reorganization
 - Reasonably Equivalent to the Value or Interest Received
- Market Test: right to retain equity has value

Feasibility

- Confirmed Plan Must Not Be Likely to Be Followed By Liquidation or Further Reorganization
- Debtor Need Not Guarantee Success, But Must Have Reasonable Prospect of Success
- SARE Factors
 - Length of Restructured Mortgage and Amount of Balloon Payment
 - Condition of Subject Property
 - Occupancy Rate and Status of Leases
 - Ability to Meet Operating Expenses and Mortgage
 - Ability to Obtain New Financing