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Consensual Resolutions of Distressed Loans

Evaluating Modifications, Forbearance Agreements, Deeds in Lieu,
Short Sales and Other Options for Loan Workouts

WEDNESDAY, MAY 2, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Adam B. Weissburg, Partner, **Cox Castle & Nicholson**, Los Angeles

Gregory G. Gosfield, Partner, **Klehr Harrison Harvey Branzburg**, Philadelphia

Yolanda Rodriguez, General Counsel, **O'Neill Properties Group**, Philadelphia

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May 2, 2012 | 1:00pm – 2:30pm EDT

Gregory G. Gosfield, Esquire
Klehr Harrison Harvey Branzburg, LLP
1835 Market Street
Philadelphia PA 19103
215-569-4164
GGosfield@Klehr.com

Adam B. Weissburg, Esquire
Cox, Castle & Nicholson LLP
2049 Century Park East 28th Fl
Los Angeles, CA 90067
310-284-2270
aweissburg@coxcastle.com

Yolanda Rodriguez, Esquire
O'Neill Properties Group
2701 Renaissance Blvd
King of Prussia PA 19406
610-992-5885
YRodriguez@ONeillProperties.com

Outline

- Hypothetical- Basic Facts
- Facts of the Problem Loan Applicable to All Strategies
  - Due Diligence (both sides).
    - Forensic accounting of document and issues
    - What are leverage points
    - What are the concerns
  - Goals (both sides)
    - What are you trying to accomplish
      - Recovery
      - Workout
      - Avoidance of Recourse

Outline

- Options
  - Loan Modification
    - Amendment v. Forbearance
    - Possible tools to workout
  - Friendly foreclosure
  - Deed in lieu
  - Mortgage Debt Purchase
  - Receivership
  - Bankruptcy

Hypothetical – Basic Facts

- Speculative office building under construction
- Leases in place for 25% of gross leasable area
- Money invested into deal to date: $10 million
- Current fair market value: $5 million

Hypothetical – Capital Stack

First Mortgage Loan $6 million outstanding
Mezzanine Loan $3 million outstanding
Equity $1 million invested

► If only $5 million of value exists, what survives and at what value?

Facts of the Problem Loan Applicable to All Strategies – Financial Strength Evaluation

- Financial Strength of Mortgagor
  - Financial Statements with footnotes
  - Tax Returns
- Financial Strength and Positioning of Guarantor
  - Financial Statements with footnotes
  - Tax Returns
  - Analysis of Guarantor Presence/Reputation in Market

Facts of the Problem Loan Applicable to All Strategies – Collateral Evaluation

- Value and Condition of Collateral
  - Appraisal and Market Analysis
  - Title and Survey
  - Environmental
  - Consideration of Positioning of Asset in Market, i.e. “trophy asset”

Facts of the Problem Loan Applicable to All Strategies – Loan Document Evaluation

- Inventory defaults and accompanying remedies
- Consider potential claims of invalidity of documents, lender liability, etc.
- Perform technical analysis, i.e. review for state law compliance
- Evaluate guarantor recourse

Guarantor Recourse: Recent Decisions

- *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership, et al* (2011 Mich. App. LEXIS 2360); *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Company, LLC and John Damico v. Morgan Stanley Mortgage Capital Holdings, LLC* (2011 U.S. Dist. LEXIS 142404): "Non-recourse" borrowers breached SPE covenant that required borrowers to remain solvent to maintain SPE status; courts upheld that insolvency triggered full recourse to borrowers and guarantors
- *GECCMC 2005-C1 Plummer Street Office Limited Partnership v. NRFC NNN Holdings LLC* (Los Angeles County Super. Ct. No. BC419513): When non-recourse borrower's tenant (Washington Mutual) ceased to pay rent and abandoned the property, this did not trigger breach of "bad boy" covenant requiring borrower to obtain lender consent to lease termination because lease was not terminated.

Establishing Goals – Mortgagor v. Mortgagee

- Mortgagor
  - Swift result
  - Lowest cost
  - Highest preservation of value for equity
  - Privacy
  - Prevent long-term repercussions
  - Avoid personal recourse to guarantor
- Mortgagee
  - Swift result
  - Lowest cost
  - Highest preservation of value for debt
  - Privacy
  - No precedent

Establishing Goals - Who Is Your Lender

- – Relationship Lender
- – Special Situations/Workout Officer
- – Special Servicer
- – Loan Purchaser

Loan Modification

“Delay and Pray”/“Extend and Pretend”

	Before	After
Mortgage Lender	First Mortgage Loan $6 million outstanding	•Revised deal terms which may include: -Extension -Deferrals of Payments -Positioning for future sale or conveyance of asset
Mezzanine Lender	Mezzanine Loan $3 million outstanding	•Needs to correspond/defer to first mortgage terms unless mezzanine lender is replacing borrower
Borrower	Equity $1 million invested	

Loan Modification

"Delay and Pray"/"Extend and Pretend"

Pros:	• Everyone buys time to optimize strategies • Parties can further their due diligence in a friendly setting, i.e. update of representations and warranties
Cons:	• Busy bankers/servicers have excuse to move to next item in their queue • Regulatory limitations • If borrower/guarantor are cash-starved, this may just delay the inevitable and lead to reduction in asset value

Loan Modification

"Delay and Pray"/"Extend and Pretend"

- Amendment
  - May reset terms
  - Impairment of junior creditors
  - Loss of lien priority
  - Loss of guaranty
  - Loss of special waivers
- Forbearance
  - Suspends remedies only
  - Intercreditor risks
  - Course of conduct taints enforcement
  - Less regulatory restrictions

Loan Modification –
Sample Structuring Options

- – Split current interest from operating income
- – Accrue interest on fixed/unpaid arrearages
- – Back-end loan modification fees
- – Earn out of guaranty release
- – Stipulated Judgment/Deed-in-the drawer
- – Consensual sale

Mortgage Foreclosure

	Before	After
Mortgage Lender	First Mortgage Loan $6 million outstanding	Owner of $5 million Property plus potential Deficiency Claim Against Guarantor (if not negotiated)
Mezzanine Lender	Mezzanine Loan $3 million outstanding	
Borrower	Equity $1 million invested	

Mortgage Foreclosure – Pros and Cons

	For Mortgage Lender	For Borrower and Mezzanine Lender
Pros:	• Court supervision • Routine procedures • Ability to divest, subordinate encumbrances	• ability to manipulate/create delay
Cons:	• Cost • Procedural challenges • Failure of notice • Local requirements • Public Auction dilutes transfer control	• Lose everything • Public • Cost to fight • Guarantor exposure for deficiency (if not negotiated) • Guarantor personal liability for bankruptcy of Borrower by Mezzanine Lender (if not negotiated)

Mortgage Foreclosure - Mortgage Lender Risks

- Transfer Risk
  - Defective collateral
  - Borrower bankruptcy
  - Defective sale

Mortgage Foreclosure - Mortgage Lender Risks

- Post-Transfer Risk
  - Real estate collateral incomplete for operations
  - No transfer of permits
  - No transfer of personalty
  - Must eject mortgagor
  - No transition of operations
  - Lender succeeds to liabilities that run with land
  - Lender liability claims unaffected

Deed in Lieu

	Before	After
Mortgage Lender	First Mortgage Loan $6 million outstanding	• Owner of $5 million property • Claim against Guarantor likely reduced or released
Mezzanine Lender	Mezzanine Loan $3 million outstanding	• Mezzanine Lender has claim against guarantor • Remote chance of cooperation or premium payment
Borrower	Equity $1 million invested	

Deed in Lieu – Pros and Cons

	For Mortgage Lender	For Borrower and Mezzanine Lender
Pros:	• Low publicity • Time and cost savings • Borrower cooperation • Negotiated lender release • Can preserve mortgage and clear title	• Low publicity • Cost savings • Guarantor may be able to negotiate release or even premium
Cons:	• May be considered mortgage foreclosure violation • May be subject to attack as voidable transfer	• Lose everything or almost everything • Less ability to manipulate/ create delay

Deed in Lieu – Mortgage Lender Risks

- Transfer Risk
  - Defective Collateral, but Lender better able to evaluate/mitigate
  - Deed recharacterized as mortgage
  - Borrower bankruptcy
  - Borrower failure to close

Deed in Lieu – Mortgage Lender Risks

- Post Transfer Risk
  - Improved positioning given transfer of permits, personalty and possession
  - However, risks remain that collateral will be found to be incomplete/flawed post-transfer

Mortgage Debt Purchase

	Before		At Time of Purchase		Upon Restructure
Mortgage Lender	First Mortgage Loan $6 million outstanding	Transfer to New Lender	First Mortgage Loan	Restructure	First Mortgage Loan: $3 million outstanding plus participation interest or hope note
Mezzanine Lender	Mezzanine Loan $3 million outstanding		Mezzanine Loan $3 million outstanding		Mezzanine Loan $3 million outstanding
Borrower	Equity $1 million invested		Borrower who stays in place may be able to recoup value/fees in long term		Borrower who stays in place may be able to recoup value/fees in long term

Mortgage Debt Purchase Pros and Cons

	For Selling Mortgage Lender	For Purchasing Mortgage Lender	For Borrower/Mezzanine Lender
Pros:	• Negotiated result • Time and cost savings	• Economic upside • Preserve option to foreclose/do deed in lieu in future • Chance of borrower cooperation	• Chance of continued participation • Ability to re-create lost value if remain in place
Cons:	• Loss of upside • May be residual liability to borrower or purchaser	• Often limited diligence, representations and warranties, and borrower contact • Unpredictability of keeping current borrower in place • Stigma may be impossible to overcome	• Unless mezzanine structure is re-negotiated too, may be lost cause for borrower • New economic structure may be demotivating • Stigma may be impossible to overcome

Mortgage Debt Purchase – Purchasing Mortgage Lender Risks

- Transfer Risk
  - Assignment Risk
  - Intervening Creditor Impairment
  - Seller Failure to Close
- Post-Transfer Risk
  - Successor Mortgagee Liability Claims
  - Liability to other Creditors (i.e. Mezzanine Lender)
  - Recharacterization Risk on Clogging of Equity
  - Prepayment

Receivership

Pros:	• Mortgagee can assure asset/funds not being wasted on property operations and further diligence • Mortgagor proves it has nothing to hide and earns trust
Cons:	• Mortgagor resents losing control • Costly • Taints asset image in marketplace

Bankruptcy

- Rare in consensual setting
  - Why it may work
    - Complex asset vs. straight forward single asset bankruptcy
    - Significant outstanding debts
    - Chance that foreclosure sale will not yield bidders
  - Risks
- More likely to be used as a threat to force consensual resolve, but consider:
  - *UBS Commercial Mortgage Trust 2007-FL1, Commercial Mortgage Pass-through Certificates, Series 2007-FL1 and Normandy Reston Office, LLC v. Garrison Special Opportunities Fund, L.P.* (Supreme Court of New York No. 65241212010): Court rejected guarantor's public policy arguments and held for lender in case of springing guaranty upon voluntary bankruptcy in mortgage loan.
  - *Bank of America, N.A. v. Lightstone Holdings, LLC* (Supreme Court of New York No. 601853/09): Summary judgment granted to lender who pursued springing guaranty upon voluntary bankruptcy in mezzanine loan.

Conclusion

– Each option poses pros, cons, challenges, and risks
– Deal specifics drive deal result for all parties
– Questions/Comments?