

THE INs AND OUTs OF COMPLEX COMMERCIAL FORECLOSURE PROCEEDINGS



Presented by:

John R. Engel

Sullivan Hill Lewin Rez & Engel, San Diego, CA

Zev Gewurz

Goulston & Storrs, Boston, MA

Robert F. Higgins

Lowndes, Drosdick, Doster, Kantor & Reed, Orlando, FL

Rob Seidenwurm

Fidelity National Default Services, San Diego, CA

WAVE OF FORECLOSURE?

- Commercial real estate loans have terms of three to ten years, but the monthly payments are not scheduled to repay the loan in that period.
- If the borrower cannot refinance the property when the loan term ends or pay interest and principal during the loan term, the loan will default and the property will face foreclosure.
- Between 2010 and 2014, about \$1.4 trillion in commercial real estate loans will reach the end of their terms. Nearly half are at present “underwater.”
- A significant wave of commercial mortgage defaults is likely to trigger increased foreclosure activity, note sales, and deed-in-lieu transactions.

Source: Executive Summary, Congressional Oversight Panel, February 2010 Oversight Report, “Commercial Real Estate Losses and the Risk to Financial Stability” available at cop.senate.gov

PRE-FORECLOSURE DUE DILIGENCE

- **Review Loan Documents**
 - Understand default provisions, grace periods, notice requirements, default rates, late charges, and limitations on the exercise of remedies.
- **Evaluate Liable Parties**
 - Borrower, Guarantors, etc.
- **Assess Your Legal Position**
 - Are there irregularities, glitches or potential lender liability claims?
 - Can the chain of title to the Note and Trust Deed be conclusively established?

PRE-FORECLOSURE DUE DILIGENCE

■ Condition of Title

- Order Title Report, understand title problems, and verify outstanding real estate taxes.
- For development projects, has legal description changed? Are there new APNs?

■ Collateral Value and Appraisal

- Oversecured or Undersecured?
- What is the correct amount of interest to include: default rate, late charges, adjustable/variable.

PRE-FORECLOSURE DUE DILIGENCE

- **Condition of Property**

- Order environmental report, evaluate status of permits and approvals, payment requisitions and lien waivers for construction projects, review significant contracts.

- **Leases**

- Review estoppel certificates and SNDAs, assess priority and availability of lock-box arrangements.

- **Co-Lenders and Mezzanine Lenders**

- Are there any co-lenders, mezzanine lenders, or governmental agencies? Review inter-creditor agreements.

DEVELOP YOUR FORECLOSURE PLAN

- Foreclosure Alternatives
 - Forbearance, Modification, Short Sale, Deed in Lieu, Rights under the Guaranty.
- Judicial versus Nonjudicial Foreclosure
- Effect of Mixed Collateral, Multi-jurisdictional Collateral and Choice of Law
- Pre-foreclosure Provisional Remedies
 - Receivership
 - Injunctive Relief
 - Rent Collection
 - Pre-judgment Attachment

DEVELOP YOUR FORECLOSURE PLAN

- Hire Professionals
 - Foreclosure company, trustee, title insurer, appraiser, environmental and property engineer, and property manager
- Bidding Strategy

CALIFORNIA FORECLOSURE SUMMARY

- California as the basis for other West Coast states – others are variations on the same theme.
- Both nonjudicial and judicial foreclosure are available and may be pursued simultaneously. No election of remedy is made until the trustee's sale occurs or a judgment is obtained.
- A deficiency judgment may be obtained only when the property is sold through a judicial foreclosure. No deficiency judgment is allowed after a nonjudicial foreclosure sale.
- Nonjudicial foreclosure can be completed in as little as 4 months. Judicial foreclosure is likely to take from 6 to 18 months.

TRUSTEE'S SALE GUARANTEES

- At the time of Notice of Default – Trustee will order a Trustee's Sale Guarantee. It looks like a title policy, but it is an examination of title only, the purpose of which is to identify the parties who must be given notice of the sale.
- Also valuable peek at title if it has not already been examined.
 - Are there Deeds of Trust or liens (recorded either before or after the subject Deed of Trust)?
 - Recorded Prior – In many cases, these are documents that should have been reconveyed, but were not. Or they may be senior to your lien.
 - Recorded After – Might the junior lienholder be willing to buy the subject Deed of Trust, reinstate or service your loan?
 - Are there mechanic's liens on the property – senior or junior?
 - Based on the above, does my strategy change?
 - Critical to verify that the legal description actually correlates to the property.

CALIFORNIA FORECLOSURE SUMMARY

- The secured loan may be **reinstated** by paying the unaccelerated balance due and certain costs and fees during various periods before the sale (5 days before the sale in the case of nonjudicial foreclosure or prior to the entry of a judgment of foreclosure in a judicial foreclosure) and may be **redeemed** by paying the full amount due before the foreclosure sale. As a practical matter, reinstatement often impossible (loan matured or other non-monetary defaults).
- There are no post-sale redemption rights after a nonjudicial sale. Unless the beneficiary waives its right to a deficiency judgment in a judicial foreclosure action, the period during which the property may be redeemed from a judicial foreclosure sale is 3 months if the sale proceeds were sufficient to satisfy the secured debt plus interest and costs, and 1 year if the sale proceeds were not sufficient to satisfy the secured debt plus interest and costs. The debtor retains the right to possess the property during the redemption period and the foreclosure purchaser is entitled to receive from the person in possession the rents and profits from the property or the value of the use and occupation of the property.

MIXED COLLATERAL

1. Unified Nonjudicial Foreclosure

- No deficiency
- Real property law plus UCC commercial reasonableness
- Excluded real and personal property remain subject to lien
- When the combination is worth more than its parts (e.g., hotel, restaurant, manufacturing plant)

2. Unified Judicial Foreclosure

- Deficiency judgment available (unless standard purchase money mortgage under CCP § 580b or barred by nonrecourse provision)
- Excluded personal property remains subject to lien
- Lien on excluded real property is lost

MIXED COLLATERAL

3. Foreclose Only on Personal Property

- Dispose under UCC
- Obtain deficiency judgment
- Lose lien on any real property security (under CCP § 726 one form of action rule)
- When real property has little or no value

4. Judicial Foreclosure on Real Property and Nonjudicial Sale of Personal Property

- Deficiency judgment available unless barred by purchase money under CCP § 580b or nonrecourse provision
- Lien on any excluded real property is lost
- Problems in allocating debt between real and personal property collateral

MIXED COLLATERAL

5. Separate Nonjudicial Sales of Real and Personal Property
 - No deficiency judgment after trustee's sale of real property
 - When quick remedy outweighs need to preserve deficiency claims

PROVISIONAL/ANCILLARY REMEDIES

- Receivership
- Injunctive Relief
- Collection of Rents
 - California Civil Code § 2938 (assignment of rents)
 - by receivership
 - by obtaining possession
 - by demand on tenants
 - by demand on landlord–assignor
- Pre-Judgment Attachment

CREDITOR'S BIDDING STRATEGY

- Consider audio taping or videotaping the auction, particularly if you suspect bid chilling, other anti-competitive activity or other problems.
- A full credit bid or a credit bid at more than the property's value will preclude recovery from other collateral and may preclude recovery for tortious conduct not covered by the anti-deficiency rules.
- Important to ascertain what the sale is trying to accomplish when developing bidding strategy. If using as a sale possibility, lower than market value bid may be necessary.

CREDITOR'S BIDDING STRATEGY

- A higher bid may be desirable if taxing authorities may redeem after sale (e.g., under IRC § 7425 federal tax liens recorded more than 30 days before the sale date are not extinguished by the sale unless the IRS was given notice at least 25 days before the sale date; and even if extinguished the IRS can redeem within 120 days after the sale date by paying bid amount plus other statutory amounts). After sale, consider requesting waiver of right of redemption from the IRS. As a practical matter, the property is not marketable until the right of redemption lapses, but with a higher than market value bid, it might be.

EXAMPLE OF WHAT CAN GO WRONG

In Millennium Rock Mortgage, Inc. v. T.D. Service Company, 2009 WL 4048660, the auctioneer used a script to conduct the trustee sale. The script included the trustee sale number, a legal description of the property, the property address and the opening credit bid amount of \$51,000. However, the auctioneer called out the street address of a different property for which the credit bid amount was \$383,000 rather than \$51,000. The purchaser bid slightly over the \$51,000 credit bid. The mistake was discovered after the sale but before delivery of the trustee's deed. In California the trustee may rescind the sale and return the purchaser's funds with interest before delivery of the trustee's deed only where there is an irregularity, unfairness or fraud in the foreclosure proceedings. The court held that the gross inadequacy of the price plus the ambiguity in determining which property was being sold warranted rescission of the sale.

BANKRUPTCY

- A Bankruptcy prior to a foreclosure sale automatically stays the sale. Note that the bankruptcy can be not only by the Borrower, but also junior lienholders.
- Recently, spate of “invented” bankruptcies – New Deed of Trust recorded just prior to sale. Beneficiary under that Deed of Trust declares bankruptcy, and invokes the stay.
- A new form of frivolous litigation.

TAXES

Change in Ownership

Foreclosure or a transfer in lieu of foreclosure constitutes a change of ownership for Proposition 13 purposes (see, 18 California Code of Regulations § 462.120).

Documentary Transfer Tax

In the case of deeds and transfers to a beneficiary or mortgagee as a result of or in lieu of foreclosure, the documentary transfer tax is payable only to the extent that the consideration paid exceeds the unpaid debt plus accrued interest and costs of foreclosure (see, California Revenue & Taxation Code § 11926). In the case of a third-party foreclosure purchaser, the tax is based on the purchase price paid, without regard to (exclusive of) the amount of any unpaid debt remaining on the property after the sale (see, *Brown v. County of Los Angeles*, 72 Cal. App. 4th 665, 85 Cal.Rptr. 2d 414 (1999)).

POST FORECLOSURE PLAN

- Obtaining Possession
- Collecting the Deficiency
- Reselling the Property
- Deal with IRS Postsale Redemption Right
 - Wait 120 Days
 - Contact IRS for early lien release

FORECLOSURE IN MASSACHUSETTS: OVERVIEW

- Massachusetts has non-judicial foreclosure/Statutory Power of Sale.
 - Notice requirement of publication once a week for three successive weeks, with the first publication being at least 21 days before the sale.
- The process can be completed quickly, in as little as 4 weeks from the time it is commenced.
 - A 2007 law provides for a 90-day right to cure for 1-to-4 family homes.
 - Timeframes are extended if the Servicemembers Civil Relief Act applies.
- The mortgagee may preserve rights to a deficiency judgment by giving statutory notice to the borrower and executing an affidavit.
 - Notice must be delivered at least 21 days before the foreclosure sale, and the affidavit must be executed within 30 days of the foreclosure.
 - The statute provides forms for both the notice and the affidavit.

FORECLOSURE IN MASSACHUSETTS:

Overview (cont'd)

- If the property is properly sold pursuant to the power of sale, the borrower has no right of redemption.
 - The power of sale is often accompanied by “foreclosure by entry” onto the property to protect the mortgagee from technical challenges, as entry extinguishes the right of redemption after 3 years.
- Servicemembers Civil Relief Act
 - Federal statute under which a lender cannot foreclose on property owned by military personnel while they are in active service or for three months thereafter.
 - Massachusetts requires an additional filing, which can take an additional 6–10 weeks, to ensure that SCRA does not apply whenever the borrower is a natural person, a Massachusetts nominee trust, or a general partnership or JV in which any partner is a natural person.
 - “Fast-track” foreclosure (conducting the sale before this procedure is completed) is risky because it may create a cloud on the title.

RECEIVERS

- The availability of receivers varies by state.
- Receivers, where available, are officers of the court who are appointed to manage the property during the foreclosure process.
- PROS
 - Immediate possession, control, and capture of revenue.
 - Prevents the borrower from assembling a “war chest.”
 - Ability to improve the property and allows time to structure the sale.
 - Can insulate the lender from lender liability claims.
- CONS
 - Expensive.
 - Receivers cannot be selected by the lender, are not the lender’s agent, and may act independently (“run away” receiver).
 - Trying to control a receiver can give rise to mortgagee-in-possession claims and potential lender liabilities.
 - Can be hard to remove the receiver and reverse the process.

RECEIVERS IN MASSACHUSETTS

- Receivers are rarely available in Massachusetts state courts.
 - Some lenders, especially with CMBS loans, have had success recently obtaining federal receivers.
 - There must be diversity jurisdiction to get into federal court.

COLLECTION OF RENTS IN MASSACHUSETTS

- In Massachusetts, the mortgagee can collect rents if there is a properly recorded assignment of leases and rents from the debtor/landlord.
- The mortgagee must be very careful: in demanding rents, mortgagee must be explicit that it is acting as assignee and not as mortgagee.
 - Otherwise, absent an SNDA, the mortgagee could inadvertently terminate subordinate leases (under the doctrine of “paramount title”).

DEEDS IN LIEU

■ PROS

- Quick and efficient delivery of the property to the bank.
- Can eliminate negative publicity associated with foreclosure.
- Eliminates uncertainty of foreclosure auction.
- Because it's cooperative, the borrower is more likely to facilitate dealings with tenants, co-developers, and other interested third parties to access documents.
- Can be less expensive than foreclosure.
- Permits leases and other beneficial interests to remain in effect.

■ CONS

- Same risks as any property transfer.
 - E.g., exposure to liabilities under leases and contracts, possible environmental liability, etc.
- The bank takes title subject to all junior and senior liens and encumbrances.
 - Must assess in each state whether the bank can take title in an affiliated entity and foreclose later.
- Risk of fraudulent conveyance claim.

ISSUES OF ENVIRONMENTAL LIABILITY UNDER FEDERAL AND MASSACHUSETTS LAW

- Secured lenders who foreclose risk potential environmental liability risks under both federal and state law as well as the financial risks associated with owning an asset that may be worth much less than anticipated because of the presence of contamination.
- Both federal and state laws impose liability on any “owner” or “operator” of polluted property.
 - Federal law: the Comprehensive Environmental Response, Compensation, and Liability Act (“CERCLA”).
 - State law (e.g., the Massachusetts Oil and Hazardous Material Release Prevention and Response Act a/k/a Chapter 21E).

ENVIRONMENTAL LIABILITY (cont'd)

- Federal protections for secured lenders:
 - CERCLA exempts secured lenders who do not participate in managing a site and who simply hold ownership to protect their security interest.
 - Foreclosing lenders must diligently try to divest themselves of the property to remain exempt.
 - Performing due diligence before taking title may also allow lenders to gain additional protection as bona fide prospective purchasers as long as they satisfy the “All Appropriate Inquiry” (“AAI”) standard.
 - Pre-foreclosure due diligence may also allow an asset to be valued properly.

ENVIRONMENTAL LIABILITY (cont'd)

- State protections for secured lenders:
 - The Massachusetts statute exempts secured lenders who meet certain enumerated statutory requirements, but these can be onerous and expensive and are somewhat complicated.
 - Among other things, secured lenders must not have contributed to the pollution; must notify the Department of Environmental Protection and potential bidders about known hazards; must take reasonable steps to prevent hazardous exposure; must abate “imminent hazards” (“IH”) and “conditions of substantial release migration” (“SRM”); and then must diligently work to divest themselves of the site.
 - Note: IH and SRM conditions can be expensive to address, which is another reason to perform appropriate due diligence.
 - The protection is also limited: it only applies to “releases” or “threats of release” that first begin before the lender acquires ownership or possession of the property.

MASSACHUSETTS TRANSFER TAX ISSUES

- In Massachusetts, foreclosures and deeds-in-lieu are both subject to transfer taxes calculated on the consideration for the transfer.
- Consideration in foreclosure is the bid price; consideration in a deed-in-lieu is the amount of the debt being forgiven, plus any cash paid to the borrower.
- Applicable transfer taxes when taking title “subject to” the mortgage.
 - In Massachusetts, the transfer tax is calculated on the consideration paid less any “lien or encumbrance remaining on the property.”
 - If any affiliate were to take title to property “subject to” the existing mortgage, the affiliate could argue that transfer taxes should apply only to the consideration paid less the assumed mortgage, which may result in zero transfer taxes.
 - This position is not without risk, depending on the facts and circumstances of each case.



FLORIDA FORECLOSURES WELCOME TO FLORIDA'S WONDERLAND

Presented by: Bob Higgins

REAL PROPERTY FORECLOSURES

- Florida is a “Judicial Foreclosure State,” which simply means that to foreclose a mortgage, lien or claim on real property it is necessary to file a lawsuit in the county where the property is located.
- It is necessary to join as defendants the owner and all persons or entities that may hold a junior recorded claim or lien against the property or may be in possession of the property.

PRE-SUIT TITLE WORK

- It is imperative to obtain a title report, or “Foreclosure Certificate,” before filing the foreclosure action to determine the names of holders of junior encumbrances and the liens in order to join them in the case to extinguish their interests.
- An Owner’s Policy may be written from the Foreclosure Certificate

JOINING DEFENDANT PARTIES IN THE CASE

- Defendants must be served with process and are allowed twenty days to respond to the complaint, either by answer, defense or motion to dismiss.
- If a defendant does not answer, a default is entered and it cannot later raise defenses to the action, other than as to the amount of the claim.

IN A PARALLEL UNIVERSE

- In the best of all worlds for the foreclosing party, no answers are filed.
- The foreclosing party is then entitled to a final judgment of foreclosure upon submission of an affidavit substantiating the debt and claims.
- Fat Chance of that in Today's World.

THE DREADED DEBTOR DELAYING TACTICS

- The lender's timetable can be seriously upset if the owner decides to mount a defense.
- Owners or other defendants are allowed to raise any type of defense to the foreclosure suit, such as the traditional "lender liability" claims, or some other type of alleged misconduct by the lender can delay the lender in completing the foreclose.
- In Florida, foreclosures are considered to be "equity proceedings." The judge is omnipotent.
- Plus, the volume of foreclosures has brought the process to a snail's pace.

SELLING THE PROPERTY

- Once a final judgment is entered, the property is sold by the Clerk of the Circuit Court at public auction.
- The foreclosing party is entitled to bid the amount of its final judgment as a credit bid.

BIDDING AT THE SALE CLERK'S

- The amount of the bid at the foreclosure sale is important because there is a documentary stamp tax of seventy cents for every hundred dollars of bid.
- Florida law provides that a minimal bid is sufficient to pass good title to the buyer, so long as the foreclosure sale has been regularly conducted.
- As a result, lenders do not need to “bid in their judgment,” unless there is a junior SBA mortgage or IRS lien.

DEFICIENCY CLAIMS

- Deficiency claims are based upon the difference between the amount of the final judgment and the greater of the true value of the property foreclosed as of the date of the sale and the sale bid price.

RIGHT OF REDEMPTION

- There is no statutory right of redemption after the Certificate of Title is issued, except that the IRS and SBA have certain Federal redemption rights.
- Florida Courts have held that an owner may avoid losing its property, if the entire judgment amount is paid before the Certificate of Sale is issued by the Clerk of the Court.

DEEDS IN LIEU

- Deeds in Lieu of Foreclosure are recognized in Florida, but they are rare because junior liens or encumbrances on the property are only extinguished by a foreclosure. Hence, good title information is imperative.
- A Documentary Stamp tax of seven dollars per thousand of the total amount of the debt being waived or forgiven is due at the time of recording of the deed of convenience.

REAL ESTATE TAXES AND CONDO ASSESSMENT FEES

- Real Estate Taxes are not extinguished by the foreclosure and must be paid or a tax deed sales lien will ultimately be held.
- A first lienholder is liable for six months of unpaid condo fees or 1% of the principal amount of the debt being foreclosed upon taking title to a condominium unit.

PERSONAL PROPERTY FORECLOSURES

- Personal property associated with realty, such as hotel equipment, is normally foreclosed in conjunction with the real property.
- Lenders may also foreclose security interests in rents, building plans, credits for sewer and water tap-in fees, and rights under building permits as part of the foreclosure.

RECEIVERSHIPS

- Florida statutes and case law allow for the appointment of a Receiver to manage property during the foreclosure process.
- Three theories for the appointment of a Receiver: (1) the property is wasting or deteriorating; (2) the mortgage documents allow for the appointment; or (3) the value of the property is less than the debt due.

ASSIGNMENT OF RENTS

- The Assignment of Rents Statute allows a Court to Order “any excess Operating Proceeds” to be paid to the Lender, if it allows the owner to retain possession during the foreclosure.
- This requires the Court to approve an operating budget for the property.
- A statutory “Notice of Default” and acceleration is required.

COSTS

- The State of Florida imposes the filing fee for the foreclosure of a mortgage of over \$1,000,000 in the base amount of \$1,905. Additionally, counties add extra fees.
- Title information on the property can usually be obtained for a few hundred dollars.

REALITY OF THE DRAMATIC INCREASE IN STATEWIDE FORECLOSURES

- It is no secret that Foreclosures in Florida have skyrocketed since the economic meltdown of 2008.
- By way of example, in Orange County, (Orlando) all foreclosures increased from about 4000 in 2005 to over 31,000 in 2009.
- All Counties in Florida have been slammed with new cases.

REALITY OF THE DRAMATIC INCREASE IN STATEWIDE FORECLOSURES (cont'd)

- SIGNIFICANT slowdowns have resulted in the operations of The Clerks of Court, hearing time has become much more difficult to obtain, foreclosure sales are being delayed.
- Even if a foreclosing attorney diligently moves his case, a lender might reasonably expect the process to take at least nine to twelve months.
- Foreclosures in 2010 are trending down.