ASPATORE SPECIAL REPORT

Representing Lenders in Commercial Foreclosures

Understanding the Unique Challenges of Commercial Foreclosures and the Best Strategies for Countering Borrower Defenses

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Commercial Foreclosure Strategies in a Down Economy

Lee D. Mackson

Chair, Complex Loan Workout and Creditors Rights' Practice Groups

Shutts & Bowen LLP

ASPATORE

Recent Trends in Commercial Foreclosure Activity

The number of commercial foreclosures has greatly increased in the past year. The rate of commercial foreclosures previously lagged behind residential foreclosures for a number of reasons, including (i) the condo glut caused by substantial overbuilding; (ii) the subprime lending issues; and (iii) the large number of people who bought residential property, either to live in or for investment purposes, using adjustable rate mortgages (ARMs). However, commercial foreclosures have now followed suit; and although the commercial foreclosure market is still not as bad as the residential market, commercial foreclosures have been steadily increasing. Indeed, there has been a drastic increase in commercial foreclosures of all property types, and in all phases of development and construction, including office buildings, shopping centers, hotels, and residential developments.

Unique Aspects of Commercial Foreclosures

The process to foreclose on both residential and commercial properties is much the same: the borrower defaults under the terms of the loan; the lender sends a default notice; and then the lender files a complaint to foreclose on the property. The borrower then has a chance to respond to the foreclosure complaint, and the lender has to deal with whatever defenses the borrower raises. In most cases, the lender will attempt to obtain a summary judgment of foreclosure, which is the fastest route to obtaining title to the property.

Consequently, the foreclosure mechanism is largely the same in both residential and commercial foreclosures. However, in a commercial foreclosure, the lender generally wants to obtain control of the property or control of the revenues generated from the property (if any) as quickly as possible, even while the case is still being litigated. Often times the property being foreclosed on is an income producing property, such as an office building, shopping center, or hotel. Simply put, the lender does not want to allow the borrower to continue to collect the revenues generated from the property while not paying its mortgage; therefore, the lender's goal is to gain control of the property, or the revenue from the property, as quickly as possible, either by getting a receiver appointed, or through a sequestration of rents order.

Loan documents often provide that the lender is entitled to the appointment of a receiver to take control of the property from the borrower, upon the borrower's default. However, courts are not obligated to appoint a receiver solely based on such a contractual provision. Instead, the contractual provision for the appointment of a receiver shifts the burden to the borrower to establish that the property value exceeds the amount of the debt, thereby providing the lender with adequate security for the debt. If there is not adequate security, then a receiver should be appointed.

In addition to the appointment of a receiver based on a payment default and contractual provision, courts also have the discretion to appoint a receiver as a result of the failure to pay real estate taxes; insolvency of the borrower; or danger of loss, waste, destruction, and/or serious impairment of the property.

The appointment of a receiver may also be necessary where development or construction of the property has been commenced but not completed. However, unless evidence is presented of danger to the property beyond completion of the project, the appointment of a receiver is not a certainty. A borrower's failure to pay taxes on the mortgaged property also justifies the appointment of a receiver, particularly if the property is in need of repair to prevent further deterioration. The failure to perform covenants contained in a superior mortgage, such as making installment payments due thereunder, can also be sufficient grounds to warrant the appointment of a receiver. Finally, protracted litigation that postpones a foreclosure proceeding when the borrower is in default can also be considered as grounds for the appointment of a receiver. To avoid the appointment of a receiver, a borrower must present evidence showing that there is no genuine danger of impairment to the collateral or that the value of the property exceeds the mortgage debt, thereby providing adequate security to the lender for the debt.

Most commercial loan documents also provide for an assignment of rents by the borrower to the lender if the borrower defaults on its loan obligations. However, under traditional case law in Florida, the appointment of a receiver provided the exclusive means for securing control of the property from the borrower, and also virtually the only means for the lender to enforce an assignment of rents clause in a mortgage or a separate assignment of rents and leases instrument. However, as an alternative to obtaining appointment of a receiver, there now exists a Florida Statute, Section 697.07, which enables the lender to gain control over the revenue generated by income-producing property when the borrower defaults on its loan obligations. Florida law allows for the enforcement of an assignment of rents provision upon default by the borrower and demand for the rents by the lender.

Fla. Stat. § 697.07 is very lender friendly, making it much easier to gain control of the rents than it is to obtain appointment of a receiver in Florida. However, Florida's sequestration statute applies only to true "rents," and not to all income and other revenue generated by the property. For example, hotel revenues, nursing homes revenues, restaurant income, and similar revenue from the operation of a business are not generally considered "rents" within the meaning of Fla. Stat. § 697.07, and thus cannot be sequestered. When dealing with these types of properties, the lender's only means of gaining control of the cash remains the appointment of a receiver.

In short, the main difference between commercial and residential foreclosures is that in a commercial foreclosure the lender wants to gain control of the property, or the revenues from the property, as quickly as possible so that the borrower is not able to operate the property and collect the revenues from the property while at the same time not paying the mortgage.

Borrower Defenses

Borrowers rarely have valid defenses in commercial foreclosure cases as the cases are almost always brought due to the borrower's non-payment of its obligations under the loan documents. However, borrowers often attempt to delay foreclosure proceedings with frivolous defenses, largely in an effort to continue to collect the revenues generated from the property while not paying the mortgage. For example, a borrower who owns an office building that has paying tenants will want to continue collecting the rents from the property for as long as possible while not making its loan payments. Essentially, the borrower will try to delay foreclosure for as long as possible, often by filing frivolous defenses—i.e., challenging ownership of the loan documents; claiming that the lender received TARP money; asserting that the lender promised that it would not foreclose; or claiming that it is not the borrower's fault that the real estate market crashed. Some borrowers will go as far as to cite statutes that do not even apply to their loans; for example, commercial borrowers will sometimes assert claims under the Fair Debt Collection Practices Act, a statute that only applies to residential loans, and has no applicability to commercial loans.

In general, there are few legitimate ways for a borrower to defend a commercial foreclosure case unless they can establish that payment has in fact been made, and that the lender made a mistake in declaring a default. Any other defenses are usually nothing more than an attempt to delay the foreclosure proceedings so that the borrower can continue to utilize the property's revenues while not paying the lender.

Settlement Options

If a borrower believes that its property is sufficiently valuable, or is generating sufficient revenues, and does not want to lose the property, then it is more likely to be motivated to try to work out a settlement with their lender. Similarly, most lenders do not want to be in the real estate ownership business; they will be if they need to be, but that is not their objective. Therefore, if a lender believes that a borrower has been honest with it and works hard at running the property, but has simply been hit hard by the economy, then it will be more likely to work with the borrower to allow the borrower to attempt to keep the property.

There are many different ways that a settlement can be reached between a borrower and a lender, including a forbearance agreement. Under one type of such an agreement, the lender would agree not to foreclose immediately, and would allow the borrower to pay an additional amount, in addition to its regular monthly payment, in order to make up the arrearages. If the borrower fails to meet the repayment plan, then the lender can complete the foreclosure without opposition by the borrower and without having to start the process all over again. The borrower would be interested in this type of proposal if it thinks it can ultimately be successful with the property. The benefit to the borrower is that it gets a chance to repay their arrearages without losing the property. The benefit to the lender is that the borrower might make it a performing loan again, which is likely preferable to the lender taking ownership of the property, and if the borrower does not meet the repayment terms, then the lender is entitled to the immediate entry of final judgment of foreclosure without opposition. Simply put, the borrower gets a second chance to retain its property, but if it fails to meet its new payment requirements, the lender does not have to litigate any frivolous defenses—instead it gets an uncontested foreclosure judgment.

Another potential settlement area would be the possibility of the lender agreeing to release the guarantor from liability in exchange for the borrower and guarantor agreeing to the immediate entry of final judgment of foreclosure. In many commercial loans, the lender requires the execution of a guaranty of all or a portion of the debt. The guaranty may be a simple guaranty of payment in which case the guarantor agrees to pay the entire debt of the borrower if the borrower does not pay. Another type of guaranty is referred to as a "bad boy" guaranty. In a "bad boy" guaranty, the lender agrees to look to the guarantor for payment of certain amounts only if there is a violation of a "bad boy" provision, such as diverting the revenue from the property to the borrower's personal use without paying the obligations of the property. Therefore, if a borrower has run the property in an honest manner without diverting money to its own pocket, and is willing to allow the lender to complete the foreclosure without opposition, the lender might agree to release the guarantor from any potential liability.

Strategies to Employ and Signs to Look For

Lender's counsel needs to be as aggressive as possible in this economy—aggressive in terms of pushing a case forward—because commercial borrowers will try anything to delay the foreclosure process. Borrowers often want to avoid making payments on their loan while still collecting revenues from the property. Therefore, a lender's attorney needs to avoid getting caught up in dealing with frivolous defenses and irrelevant discovery issues; rather, being aggressive and moving for summary judgment as quickly as possible, even with defenses and discovery issues still pending. Lender's counsel needs to convince the judge of their client's position, and to make the judge understand that the borrower's defenses are nothing other than a delay tactic in order to keep the property revenues without making payments under its loan.

Additionally, prior to negotiating with borrowers, lenders should require a pre-negotiation agreement to be executed. The pre-negotiation agreement provides that while the parties agree to negotiate, no enforceable agreement will have been reached unless and until an agreement is reduced to writing and is signed by all parties. The pre-negotiation agreement essentially prevents either party from claiming that promises were made during negotiations or that some type of settlement agreement was reached, unless such an agreement is in writing and signed by the parties.

There are signs that an attorney should watch out for that indicate that the borrower intends to delay the proceedings for as long as possible. Those signs would include filing non-meritorious defenses and/or irrelevant discovery requests. For example, the borrower may assert defenses or serve discovery regarding the lender's ownership of the loan documents or the lender's receipt of TARP funds. Consequently, such irrelevant defenses or discovery requests are usually a good indication that the borrower is just trying to delay the foreclosure process as long as possible.

Helpful Resources

While there are no special resources in representing lenders in commercial foreclosure proceedings, counsel should stay on top of changes and trends in this practice area, including reading the relevant advance sheets that cover new legal decisions in all areas of the law. Additionally, in order to successfully represent lenders in commercial foreclosure cases, counsel for the lender needs to have a good understanding of real estate loan documents. Counsel must be able to understand complicated real estate provisions. They must also be familiar with the many key areas of commercial foreclosure law, such as receiverships, sequestration of rents, and prepayment premiums. Simply stated, an attorney unfamiliar with these issues and the relevant case law may hurt their client. This is a specialized area of the law that requires a certain expertise by counsel in order to effectively represent their clients.

Final Thoughts

The number of commercial foreclosures will likely continue to increase for the foreseeable future. The commercial property market may not be quite as bad as the residential property market, but it does not appear as if the increasing commercial foreclosure trend will end anytime soon. Even when the economy begins to turn around, it will take quite a while for the commercial real estate market to catch up to the economy; consequently, we will probably have at least another two or three years of substantial commercial foreclosure activity.

My advice to other attorneys in this practice area is to know your loan documents well and to review them carefully; to know the law in the state where you are practicing; to know the weapons that lenders have in your state to gain control of the property and/or the revenues from the property as quickly as possible; and to not allow the borrower to delay the foreclosure proceedings with frivolous defenses or discovery.

Indeed, lender's counsel must always be aggressive and not let a borrower's delay tactics derail obtaining control over the property or revenues and final judgment of foreclosure as quickly as possible. Many younger and less experienced lawyers in this field make the mistake of getting bogged down in frivolous defenses and irrelevant discovery. If attorneys go into this area without experience, their tendency will be to litigate the borrower's defenses and discovery—which is exactly what the borrower is trying to lead them into doing— because litigation takes a long time, and the borrower is trying to continue to run the property, generate revenues, and not pay its mortgage. Therefore, lender's counsel must learn to deal with those issues while simultaneously moving forward as quickly as possible towards obtaining a final judgment of foreclosure, a receiver, and/or sequestration of rents.

Lee D. Mackson is the Co-Chair of the Creditors' Rights Practice Group at Shutts & Bowen, a law firm with more than 200 attorneys, strategically located in six offices throughout the state of Florida. With his knowledge of creditors' rights issues, Mr. Mackson handles cases for clients that rely on his analysis and strategic thinking. His work has been recognized by peers in the industry who named him among the top 2% of attorneys in Florida Trend's *"Florida Legal Elite." He also received an "AV" or top rating in the Martindale-Hubbell. With more than 25 years of experience, Mr. Mackson advises clients in a variety of complex business disputes. From workout attempts to commercial foreclosures and trials, he counsels clients in ways to resolve issues in court, arbitration or negotiation. He has also appeared before the United States Supreme Court, and has traveled to South Africa to testify as an expert witness on Florida real estate litigation. Although he works within various industries, Mr. Mackson focuses on serving financial institutions in real estate and banking litigation. He represents numerous multi-state lenders and special servicers, including the handling of multi-million dollar commercial foreclosures. These cases often involve receiverships and rent sequestrations. He is also involved in complex workout negotiations.*

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