NAVIGATING THE ROCKS AND SHOALS OF A MIXED USE OR HOTEL WORKOUT
ABA RPTE Spring Symposia Program
Philadelphia, PA
Thursday May 6, 2010 8:30-10 AM Downtown Marriott Hotel
Presented by:

Hospitality, Recreation and Common Interest Developments Group

Speakers:

1. Nancy Leary Haggerty, Michael, Best & Friedrich, LLP, Milwaukee, Wisconsin, Moderator, and Sections 1, 3 and 4.

2. Michael Hirschfeld of Dechert, New York, Section 6.

3. Ken Samuelson of Samuelson Law Offices, Washington, D.C., Sections 2, 5, and 7.

Outline:

1. General issues. *Nancy*

2. Convincing the Lender to stay the foreclosure during negotiations. *Ken*

3. Negotiating with condo/hotel unit owners, timeshare owners, major retail tenants, and their lenders, and the associations governing each. *Nancy*

4. Coordinating your business solution with municipal development agreements, TIF obligations and other governmental incentive programs. *Nancy*

5. Keeping the underlying business running during the workout process. *Ken*

6. Tax impacts of forgiveness of indebtedness. *Mike*

7. Incorporating remedies in case negotiations implode. *Ken*

1. General Issues. Nancy

Foreclosures and workouts of single use properties are difficult enough, but the issues become compounded when the property is a hotel, a shopping center or other mixed-use property. The deals we loved to put together over the last few years, involving developers, lenders, municipalities providing TIF or other governmental incentives, anchor tenants who own their pads, retail or office tenants who lease, perhaps with options to extend or purchase and lenders of their own, and individual residential, commercial or condo/hotel unit buyers, are very tricky to take apart. It becomes clear very early on that if the parties want to exercise their egos, play tricks, and threaten or carry out full scale war, they can do so, and everyone will lose. It is evident that that a mixed use project has its highest value as a going concern, and if the players are willing to work together, they can end up with a better result for everyone.

We will sometimes use a condo/hotel resort as our primary example, because these projects have all the same issues as a shopping center or commercial development, but since the "renters" are making their decision to use a room on a night by night basis, the issues become more immediate because the "tenants" change all the time.

We arranged our presentation by a rough timeline of when the issues come up in a workout, and will switch back and forth speaking on the segments. Ken will speak first about convincing the lender to stay the foreclosure during negotiations, to make it clear that you are honoring the lender's priority, but trying to calm any fears that will turn business away. I will then speak about keeping the unit owners, timeshare owners, tenants and associations calm, and dealing with the Development Agreements and other governmental incentive programs which may have funded parts of the project. Mike will speak on the more technical aspects of the tax implications of foreclosure, bankruptcy and workouts, so you don't negotiate out the perfect deal only to have the tax result change everything. Ken will then wrap up with advice on how to work the remedies so you have a safe place to pull back to if negotiations implode. Mike's outline is more technical and Ken's and mine are more practical.

2. Convincing the Lender to Stay the Foreclosure During Negotiations. Ken
(See Ken's outline)

3. Negotiating with Condo/Hotel Unit Owners, Timeshare Owners, Major Tenants, and their Lenders, and the Associations. Nancy

-Starting point may be to sign an agreement that allows all parties to discuss options without fear of estoppel. See Ken's outline for the contents of a good forbearance agreement.

-Next point, for emotional reasons, is to explore what power each party has to enforce its rights if they go all the way, and what rights they will lose if other parties in the project similarly behave, so the stark reality of what they can lose is in front of them.

-If the parties' concerns are the "what if" possibilities, make agreements that will only go into effect if certain milestones are met, or terminate if other events occur, such as filing of bankruptcy, entering of a judgment, sheriff's sale, etc.

-Negotiate lease amendments with tenants giving them something they may want in the long term in return for something you need now. Tenant may be willing to waive a right of first refusal on an outlot, or a right to terminate the lease early, or a right to approve changes to a shopping center, in return for a longer lease term with predictable rent, a higher base rent with no CAM adjustments, etc. In some states, individual provisions of a lease can be condemned, such as the right to block changes to the common elements of the shopping center. Showing you can condemn that right or otherwise foreclose it may encourage them to trade it for something they need more like certainty in rent, more reserved parking spaces, and option to expand into surrounding space, etc.

-In a resort setting, look carefully at what the individual hotel user or condo/hotel unit owner have the right to use, and your ability to terminate certain "resort" services which were being provided to unit owners but were not contractually promised to them. The lender may be able to start charging for services or amenities that had previously been provided for free, and create extra cash flow.

-If during the foreclosure, marketing efforts are cut back so there is no rental income to condo unit owners, many will go into foreclosure themselves. Residential unit lenders have a tendency to just look for a cheap way to foreclosure the unit, without looking realistically at how they are injuring the value of the unit they are taking back in foreclosure, or how their actions will cause the stream of rental income from that unit to be stopped, thus increasing to the foreclosing lender, the carrying costs, and the credits they will need to provide to a purchaser of that unit after foreclosure.

-Depending on the priority of Condo Association liens in your state, the Condo Association may be named as a party in unit foreclosure actions. Association will need a budget for responding to these legal actions. Check the Bylaws to see if the

Association has the right to make a special assessment against a unit for the legal fees it incurs to defend itself in these foreclosure actions, responding to any receiver, etc. Check to see if this type of special assessment has priority in your state.

-A foreclosing lender may or may not be liable for delinquent association fees in your State, but even if they are not, the purchaser after a Sheriff's Sale will likely require a credit against the purchase price which reduces the net recovery to the lender.

-Some foreclosing lenders are choosing not to actually foreclose against a unit, but instead to put the unit owner into a receivership which the lender controls. Check your State's statutes to understand when that foreclosing lender ceases to be just a lender and becomes a unit owner for purposes of being liable for condominium association fees, having the right to vote, having the right to notice of association meetings, etc.

-Unit lenders often forget about the Rental Management Agreement for a condo/hotel unit, or don't understand it and allow unit owners to pocket that income while paying no mortgage payments. The RMA is usually not recorded, and therefore operates in a foreclosure like an unrecorded lease. A foreclosing lender can assume the RMA after the sheriff's sale, and continue to receive the income, if the RMA language does not terminate expressly on a change in ownership of the unit. If the lender does not name the manager of the RMA as a defendant in the action, nor "john doe tenants" or some other defendant named to terminate any rights of possession, then technically the RMA can survive the foreclosure and the lender may be able to sell the unit subject to the RMA.

- Resort managers would prefer to keep the RMA in place and can move income to the then-current owner of the unit. It is important that the RMA give the RMA manager the right to deduct from net rental income, association fees, property taxes, and attorneys fees incurred in dealing with the foreclosure and resale.

-Some of the thorniest issues have to do with personal property. Most lenders take a security interest in the fixtures, equipment and personal property in the unit, but they almost never foreclose on that personal property which is needed to keep the unit in rentable condition. In a building where almost all of the units are in the rental program, a failure of the foreclosing lender to also take title to the standard package of personal property, could mean a substantial expenditure to buy a new furniture package, or a substantial deduction off the eventual sale price for the new buyer to buy a complete furniture package, before the unit can qualify to enter the rental pool again. Remember that the original developer probably bought that furniture and furnishings package as part of a big bulk buy, and individual replacement will be more expensive.

-If there is an Owner's closet in the unit, and the Owner has left personal property in that closet after a foreclosure, the RMA manager or foreclosing lender may need to follow the rules in your state for abandoned personal property.

-Similarly, most RMAs have provisions that a percentage of each month's income is put into a replacement reserve. Check the language of the RMA to understand to whom that replacement reserve belongs. A good RMA will require that reserve to stay to pay for all remaining expenses the delinquent unit owner owes to the developer or association or owes under the RMA.

-If the unit owner files for bankruptcy, does the RMA become rejectable? Can the manager of the RMA continue to withhold expenses before it arrives at the amount of net income? Can the RMA manager continue to enforce setoff provisions in the RMA? What if the unit is jointly owned and only one of the owners is in bankruptcy? Is there a risk of disgorgement in case of unit owner's bankruptcy?

-From the RMA manager's perspective, how can RMA manager commit rooms when doesn't know date of Sheriff's Sale? Did the foreclosing lender notify the association of change of ownership as required by Bylaws? If not, can't vote. Are Owner's night reservations cancelled? When? After Sheriff's Sale?

-Can foreclosing unit lender start a competing rental program under the terms of the RMA? Bylaws?

-Can you decondominiomize all or part of the project? May be the best practical way out if only a few units were sold. Can you amend the Declaration to expand or contract the condominium area? Can you swap units to carve out an area of the project that is owned free and clear by the foreclosing lender and allow them autonomy to deal with that area? Can the lender exercise the Developer's rights to add more units, and expand the Board to allow more voices on board.

-Contract condominium and just leave easements or deed restrictions over expansion land. Lender has sole control over that land, doesn't have to pay assessments, and smaller number of overall votes in condominium.

-Timeshare projects are difficult because for each physical unit you have multiple owners who each need care and handling. The perceived value of a timeshare unit includes the right to exchange. When the available exchange options are lessened may see defaults especially on financed purchases. Timeshare unit owners very sensitive to instability in resort since their value relies on having that project stay available for years to come.

-In order to keep the project as a going business, a foreclosing lender must make sure it has rights to, has foreclosed on, and has control over, a wide variety of security interests in trade names, trademarks, domain names, websites, reservation software and hosting agreements, software for keyless entry cards, software for billing for mini-bars, rooms, video games and pay per view movies, ownership of liquor in minibars, liquor licenses for bars, ownership of the food and liquor stocking the restaurants and lounges, directory ads, billboard contracts, radio time and television time buys, contracts with web hosting companies, advertising agencies reserving media time, room night reservations for travel agents, memberships in national marketing associations, exchange agreements with timeshare exchange clubs, hotel flag agreements, municipal and zoning permits that may not be assignable, stock in gift shops, contracts with arcade games, laundry services, pest control services, security services, beauty salon operators' licenses, and of course, reservation agreements for conventions, weddings and regular guest stays going far into the future.

-Because a hotel or resort is a going business, a date of turnover, whether by sale, assignment or foreclosure, creates an artificial break of that ongoing business. The workout deal must address advance deposits and forfeited deposits, all payables and receivables, contested credit card issues, timeshare exchange agreements and termination of rights to exchange or use a reserved exchange night, new equipment warranties and service contracts for major physical systems like elevators, equipment leases, agreements with utilities for emergency generator power or reduced rates for reduced service in peak times, vendor contracts for liquor deliveries, and liens on unsold liquor stock; delinquent real estate and personal property taxes.

-You may need a site control agreement, giving you the standing to negotiate with a municipality, hotel licensor, and other parties.

4. <u>Coordinating Your Business Solution with Municipal Development Agreements, TIF Obligations and Other Governmental Incentive Programs. Nancy</u>

-When a project is unsuccessful, the condos and timeshares are likely to be selling for far less than they originally sold for, which also means that they may be ripe for a property tax assessment challenge. One way a resort developer can increase perceived value and cash flow to his unit owners, is to have the taxes reduced so the same amount of rental room nights produces a greater cash flow to the unit owner, and consequently keeps the appraised value of the unit from falling further. However, if the project was partially funded with Tax Increment Funding, or with another governmental incentive dependent upon retaining a level of assessed value, this action must be balanced against the effect on personal guarantees of the developer in a municipal development agreement, or, even without guarantees, the impact overall on the local municipality of a reduction of tax revenue from the lowered assessment. Even though a municipality has not guaranty that a level of property tax assessment, once achieved on a project, will remain at the same level, municipalities sometimes spend money as if there will never be a reduction in either that assessment or the mill rate, and can become obligated to a stream of bond payments that cannot be met if the assessment is successfully lowered. It is important in those circumstances to work with the municipality to make certain that they have taken advantage of refinancing the bonds to the lowest rates available on the market, so that they have enough income to match their bond payments.

-Municipal Development Agreements may or may not have priority over a loan in foreclosure, depending on the priority laws of your particular state. Some Development Agreements are not recorded, but give the municipality the right to levy special assessments if the developer fails a particular criteria, such as building by a particular date or providing a definite dollar amount of assessment by a particular date. Depending on the wording in the agreement, such charges may be a special assessment with a priority the same as the development agreement itself, a priority the same as the recording date of the development agreement, or a “springing” special assessment that arises later. The priority of a spring special assessment will depend on your state’s laws.

-If a developer fails to meet all of its obligations in a Developer’s Agreement, does that mean that a municipality’s obligations to create municipal improvements like roadways, water and sewer lines, also terminate? Can be especially important for later phases in the development.

-If a development agreement allows streets, easements, lift stations and other equipment, to be dedicated to the municipality and therefore shift the burden of maintaining them to the municipality, it may make sense to get that done, but the foreclosing lender needs clear proof of authority to make that dedication.

-Many development agreements require the developer to post substantial letters of credit, cash deposits or bonds to guaranty completion, and then warranties, of municipal improvements. Many of these stay outstanding for several years as a warranty of construction of those improvements. Working with the municipality to confirm those obligations are satisfied can allow for a releases of those letters of credit or deposits. Confirm who has the right to a return of those amounts.

-If a developer has pledged to the foreclosing lender, the rights to receive TIF cashflow, what the lender does in one part of the foreclosure can hurt it in another part of the foreclosure, as a loan secured by a TIF pledge becomes underfunded. Municipalities are more open to renegotiating their development agreements, to lengthen the required development timetable, and extending the life of their TIF district, if it helps their bond rating. Special legislation is also being used to modify state requirements in TIF districts just to keep them from being deemed as failing TIFs. Especially if the municipality has been able to refinance the underlying TIF bond, and/or if the demolition of existing buildings has been delayed as well as the construction of new buildings, the TIF may stay in balance. Threat of obligation to notify TIF bond holders if there is a “material event” that there might be a shortfall, and general fear that municipality’s general fund may have to be tapped to pay for a shortfall of a TIF bond payment.

-Assignment of permits and government development agreements generally requires municipal consent. Nonassignability of DOT and DNR permits to foreclosing lender or successor owner.

-Unintended lapse of licenses like liquor licenses, variances and conditional use permits, by lack of use or assignment. Expiration of occupancy permit, building permit, building plans, or deadline dates in other municipal agreements.

-Use concept of a Parcel Development Agreement, where individual parcel buyer assumes some of prorata liability for that individual parcel, such as timing of completion of improvements, guaranteed minimum value, special assessments for improvements, and as soon as parcel owner complies, main developer off the hook.

- Municipal ordinance requirements that every condo unit owner or timeshare owner within a certain number of feet of your project needs to be notified of rezoning, conditional use, variances, etc, which just invites a public hearing that is a free for all.

-Successor liability issues for foreclosing lender and/or purchaser in sheriff’s sale for commitments made for railroad line extension, job creation or training grants, and other economic incentives, which may automatically apply to any successor operator of the business.

5. <u>Keeping the Underlying Business Running During the Workout Process. Ken</u>
(see Ken outline)

6. <u>Tax Impacts of Forgiveness of Indebtedness. Mike</u>
(see Mike outline).

7. <u>Incorporating Remedies in Case Negotiations Implode. Ken</u>
(See Ken Outline)

<u>Conclusion</u>- Nancy