"You give me a release, and I give you the keys": Borrower concerns with deeds in lieu of foreclosure

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The author of a book on business and negotiation (Mark McCormack, perhaps?) told the story of an American company that wanted to buy its distributor in Asia Minor. An official of the American company met with the owner of the distributor and came to an agreement on the price. The American said, "I'll have our lawyers draw up an agreement with all of the terms." The distributor's owner said, "No -- we already have an agreement. The agreement is that you give me a check, and I give you the keys."

At its simplest level the borrower who gives its lender a deed in lieu of foreclosure expects about the same thing: the borrower will give the lender the keys and a deed, and the lender will release the borrower from the loan. The real world is not so simple, This article discusses some of the circumstances that make the real world not so simple, and points out some of the issues on which practitioners should advise their clients who are considering giving their lender a deed in lieu of foreclosure. Most of this article is from the borrower's point of view, with a few additions to give lenders their share of sleepless nights.

After some general background, this article will discuss the issues involved with a deed in lieu of foreclosure, using four different kinds of property as examples. The four properties are (a) a shopping center, (b) a multi-tenant office building, (c) a hotel, and (d) a partly-sold condominium project.

I. Background

Let's start with the basic real estate loan. A lender ("Lender") lends money to the owner of real estate ("Borrower"), in exchange for which Borrower gives the Lender a promissory note and pledges Borrower's real estate as security for the debt. If Borrower repays the loan, then Lender releases the security; if Borrower does not repay the loan, then Lender either forecloses on the security or sues Borrower on the note.

That's an idealized picture, the equivalent of saying "ignore friction" in a physics problem, or "ignore taxes" in a financial problem. It's basically true for the ordinary home loan, but it's only an approximation for a commercial real estate loan. Why? Because a commercial real estate loan will have several parts in addition to the note and the pledge of security.

For example, Borrower may give Lender an assignment of rents, an assignment of contracts, a UCC-1 pledge of personal property, and other collateral in addition to the real estate. Borrower may also give Lender an unsecured environmental indemnity and guarantees from Borrower's principals.

Borrower may also have committed to pay amounts to Lender in addition to the loan payments, such as replacement reserves, reserves for brokerage commissions and tenant improvements, and tax

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reserves. Lender may have committed to use those reserves for those purposes, or to disburse them to Borrower, if Borrower gives Lender appropriate documentation.[1]

If Borrower repays the loan according to its terms, Lender will release the security to Borrower. Lately, however, many borrowers have given up on achieving this admirable but legally uninteresting outcome, and have become unable or unwilling to continue making their loan payments. If the property is deteriorating, the lender may prefer to take the property back quickly, with the cooperation of the borrower, rather than have it sit unattended during a long period of foreclosure. Borrowers in this situation sometimes offer to deed the property back to the lender -- to give the lender a deed in lieu of foreclosure -- if the lender will agree not to seek a deficiency judgment against the borrower, or to limit the lender's other remedies against the borrower or its principals in some other way. That bargain, and the issues for borrowers and their counsel to consider, is the topic of this article.

II. Four sticky situations

Example 1: The shopping center

Your client, Amazing Return On Capital, LLC ("AROC"), owns the Retail Valley shopping center, a strip mall with two national anchor stores and a dozen or so small in-line tenants. A few years ago, having fogged a mirror, it borrowed too much money from Big & Benevolent Bank ("B&B"), pledging the Retail Valley property and the rents as security. Two of the members of AROC guaranteed the loan, and they and AROC also gave B&B an environmental indemnity.

Time has passed. One of the anchor stores has filed a Chapter 11 petition, rejected its lease, and closed its store at Retail Valley. Several of the in-line tenants have left the center, and others are behind on the rent. Retail Valley's coffee shop tenant, Barstucks, agrees to extend its lease only if AROC cuts the rent in half. AROC can't make the mortgage payments, and sees foreclosure looming.

AROC asks B&B to restructure the loan. B&B allows AROC to make interest-only payments for a time, but the property doesn't produce enough income to cover the reduced payments. AROC asks you to propose to give Retail Valley to B&B in lieu of foreclosure if B&B will release AROC and its principals from their guarantees and from the debt.

I suggest that you should start by identifying all the obligations of AROC that relate to Retail Valley. Besides the debt to B&B, AROC or its principals may have these other obligations:

- Refundable security deposits from the tenants
- Prepaid rent
- Utility bills
- Service contracts (landscaping, parking lot maintenance, HVAC)
- Unpaid property taxes
- Local improvement assessments
- The environmental indemnity to B&B
- Incomplete tenant improvements promised in the lease
- Radius or non-competition clauses for the benefit of the anchor tenants[2]

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[1] The documentation is always appropriate if Borrower is not in default, and never appropriate if Borrower is in default.

[2] This is a clause in which the landlord (AROC) promises not to rent any space within X miles of Retail Valley to any competitor of the anchor tenant. It's the flip side of a radius clause in which the tenant promises not to open any store

- Employment agreements with staff or outside management companies for Retail Valley
- Contingent liability for real estate commissions on future lease extensions

Conversely, AROC has some assets, other than the Retail Valley center itself, that may be security for the loan, but that AROC may be able to collect or keep:

- Cash in the bank
- Unpaid rent due from the tenants
- The right to reimbursements for tenant improvement costs advanced to tenants by AROC
- Potential property tax refunds[3]
- Deposits with utility providers
- Percentage rent attributable to past sales, but not yet reported or paid

Your task in negotiating for AROC is to get B&B to release AROC from AROC's obligations on the first list, without committing AROC to hand over to B&B all of AROC's assets on the second list.

I've had the most troubles after the fact with tenant security deposits. For example, one of Retail Valley's tenants put up a $10,000 security deposit when it moved into the center. AROC deposited that $10,000 in its general bank account and it is hopelessly commingled with AROC's other funds. (AROC may not even have enough cash on hand to cover the refundable deposits of its tenants.) AROC's standard form of lease includes a provision in which the tenant releases AROC from liability for the security deposit, if AROC pays over the security deposit to a purchaser who assumes the lease. The trouble, of course, is that AROC doesn't have the cash to pay over the security deposit to B&B, and B&B isn't going to assume the tenant leases. So when the tenant moves out, it will look first to B&B (its then-landlord) for the deposit. B&B will say that it doesn't have the deposit and isn't liable for it. The tenant will then go after AROC, which likely won't have any money left at all, leaving the tenant that wants its security deposit back between AROC and a hard place.

How you advise AROC will depend on your state's case law and statutes on commercial security deposits, and on the wording of the form lease for Retail Valley: does the landlord hold the security deposit in trust for the tenant, or do state law and the lease state that the landlord is merely a debtor and not a trustee?

Example 2: The multi-tenant office building

Your client, Metro Finest Properties LLC (MFP) owns the Metro Suite project, an eight-tenant office building, which it also financed through B&B.[4] As with Retail Valley, some tenants have moved out of Metro Suite and others are having trouble paying their rent, and the Metro Suite financials have soured. MFP has stopped paying the mortgage.

B&B responded by obtaining the appointment of a receiver, who is now collecting the rents and paying the operating expenses. Market rents in the area have fallen to the point that, even if Metro Suite were 100% occupied, the income would still not cover the expenses and the debt service. MFP asks you to negotiate a giveback to B&B.

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within X miles of Retail Valley.

3 Because rents have fallen off so much, the county may be grossly overassessing Retail Valley. AROC may be entitled to seek a tax refund for part of the period when it owned Retail Valley, even after it deeds the property to B&B.

4 The loans that B&B made are purely fictional and any similarity to actual loans is purely coincidental.

One nice thing (maybe the only nice thing, from the borrower's point of view) about having a receiver in place is that the lender stops worrying that the borrower is continuing to pocket rents without paying the taxes and operating expenses. The receiver provides an adequate accounting, allowing the lender to have the Suite truth.[5]

Let's suppose that you open negotiations with B&B to deed Metro Suite to B&B in lieu of foreclosure, and that B&B agrees in principle to accept the property back. One question that you'll have to answer is at what price is B&B taking the property back? How you characterize the giveback has tax consequences for your client. In general if a lender forecloses a property without the potential for a deficiency judgment against the borrower, the borrower treats the foreclosure as a sale of the property for the loan balance. For example, if B&B were to foreclose on Metro Suite when the loan balance is $1 million, MFP treats the foreclosure as if it had sold the property for $1 million. If MFP's basis in Metro Suite is less than $1 million, then MFP recognizes the difference as a capital gain.[6] If MFP has refinanced the property, or has owned it long enough to have depreciated it faster than it was amortizing the loan, MFP may have phantom income if it gives the property back in exchange for being excused from paying the loan. Make sure your client knows the tax effect of the giveback before it signs and delivers the deed to the lender.

A change of ownership can trigger recapture of federal historic tax credits. Was Metro Suite a renovation of a historic building? Your client may have obtained historic tax credits that are still within the recapture period, and will be liable either to the government or to the tax credit investor (if there is one) when the property changes hands. The recapture phases out over time: 100% the first year after the property is placed in service, 80% the second year, 60% the third year, and so on, so if the project received tax credits and the anniversary date is coming up, delay the giveback until after the project's anniversary date.

On the other hand, if B&B accepts the property back in satisfaction of the $1 million debt, the guarantors of the loan may be very happy – they've been let off the hook for their $1 million guarantees. It may be that you end up agreeing that B&B will take the property back for less than the $1 million loan balance, but B&B gives the guarantors a covenant not to sue for the balance.

Example 3: The Home Away hotel

Now let's move things up a notch. Your client Home Away Limited ("HAL") owns the Home Away hotel, a 150-room urban hotel with a restaurant, a bar, and meeting rooms for small conventions. It has no parking lot, and contracts with a nearby office building to use its parking lot as valet parking for hotel guests. It pays its affiliate, Home Management ("Home"), to manage and operate the hotel, under a long-term management contract. HAL has no employees, but pays Home to do everything. Home hires and pays the staff, places advertising, runs the booking system, and keeps the accounts.

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5 The wordplay is a little better in the next section.

6 MFP may also have to recognize a portion of the capital gain as ordinary income if it is recapturing depreciation. That problem is beyond the scope of this presentation, so please imagine that I've included here the tax disclaimer that we add to the end of all of our e-mails now.

B&B holds the first loan on the hotel. As with Retail Valley and Metro Suite, Home Away isn't generating enough money to pay the expenses and cover the debt service. HAL asks you to negotiate a deed in lieu to return the hotel to B&B.

The first question here is whether B&B will accept the hotel at all, because it's an operating business. Home Away has some assets and liabilities that are very different from those of Retail Valley and Metro Suite. Here are a few that it might have:

- A state liquor license
- Advance bookings for rooms, and credit card deposits
- Advance bookings for conventions, and deposits for the meeting rooms
- Prepaid advertising
- Contracts with Travelocity, Expedia, Orbitz, and Priceline
- The parking contract
- A franchise or flag agreement with a national brand

Some of these are also liabilities. The advance bookings are an asset, but they are also a liability: Home Away has promised to provide the rooms on certain dates. If Home Away hands over the deposits for the advance bookings, then Home Away needs to insist that B&B take on the obligation to provide the rooms to the customers.

The contracts with the outside booking agencies may require the hotel to make a certain number of rooms available at prices not to exceed $X. The parking contract may commit Home Away to pay a minimum amount each month even if it doesn't use that many parking spaces. Home Away may have promised its franchisor to upgrade the hotel and provide certain facilities.[7] Check those contracts. Can Home Away cancel them without penalty? Does B&B want them?

Home Away may also owe room taxes to the local government. Has Home Away been filing its tax reports? Are the corporate officers personally responsible for the unpaid room taxes? Check your local ordinance.

The first question you face will be whether B&B will allow Home Management to continue to manage the hotel after HAL deeds it to B&B. Many of these contracts may be with Home Management, rather than with HAL, and can continue in force even if the underlying real estate changes hands. Watch out, though, for the liquor license, which may be tied to HAL and its owners, meaning that if the hotel changes hands without the consent of the state liquor board, Home Away may dry up until the new owners file an application and get approved. The conventioneers are going to be unhappy if they show up to a hotel that has no bar because the new owner didn't obtain the state liquor board's consent to sell alcohol by the glass.[8]

Unlike Retail Valley and Metro Suite, which don't have a lot of employees (and may not have any), Home Away has a large staff at the hotel. Home Away may owe vacation pay to its employees.

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[7] Franchise or flag agreements contain minimum standards that a hotel has to meet to retain the chain's flag.

[8] I was once involved with a hotel sale in which it was discovered shortly before closing that the liquor license, which everyone thought belonged to the hotel, actually had been issued in the name of one of the individual former owners of the entity that was selling the hotel, and could be transferred only with the former owner's consent. The former owner did consent – for a fee.

If B&B won't allow Home Management to continue to operate the hotel, then Home Management (which is an affiliate of your client) will have to terminate all of its hotel staff as of the date the giveback takes effect. Home Management may have to comply with the Worker Adjustment and Retraining Notification Act (the WARN Act), which requires qualifying businesses that lay off at least 50 people at one jobsite to give 60 days' advance notice. A business is subject to the WARN Act if it employs 100 or more full-time workers ("full-time" means 20 or more hours per week) who have been on the job for six months or more.[9] If Home Management operates a second hotel, it's likely above the WARN Act limit and has to give 60 days' advance notice to the workers at Home Away that their jobs will end. So unless B&B will allow Home Management to continue to operate the hotel, Home Management may have to tell its employees that their jobs might end in 60 days. Employee morale and customer satisfaction will fall through the floor.

A giveback in this situation is much more like the sale of a business – in fact, unless B&B will continue with Home Management, it really is the sale of a business. Your client may not be able to hand off all of its liabilities to B&B, but your client will be unhappy if it finds that it's retained more liabilities than it expected to have to keep.

Example 4: The failed condominium project

Your client, Mr. O'Reilly, through his company Basil Development, built two high-rise buildings which he platted as a 120-unit condominium and named Failte, the Irish word for "Welcome." The site includes extra land and the condominium approval contemplated a second phase with a third tower. Basil Development formed the unit owners' association, which has been charging monthly assessments since the month after the first unit was sold. Basil Development still controls the association. The state-required turnover date is still two years away.

The market turned on Mr. O'Reilly, however, and he was able to sell only 20 of the units, scattered through the two buildings, leaving 100 units unsold. He never started the third tower. When cash got tight, he stopped paying the assessments on Basil Development's remaining units. A large sum is now due, but the association has taken no steps to collect it.

Our good friends at B&B made the construction loan and have given lot releases for the 20 sold units. Their security includes the 100 unsold units. Until today, neither B&B nor Basil have thought about whether the security also includes the right to build the third condominium tower.

Why might it not? At first the security was the entire parcel of land. When Basil built and platted Failte Towers,[10] the security became the 120 condominium units and their undivided interest in the common elements. Twenty of the units, and their interest in the common elements, have since been released. The declarant's development rights to the third tower, however, may have fallen through the cracks: they aren't part of any unit, they don't belong to the owners' association, and the declaration identifies them as belonging to the developer. Maybe they transfer to the bank . . . and maybe they don't.

Under the Uniform Condominium Act (enacted by 12 states), a bank that acquires all of the declarant's units by foreclosure succeeds to all of the declarant's special declarant rights, *except* rights with respect to additional real estate, unless the mortgage being foreclosed also covers additional real

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9 This is a general statement and not an exact one. The WARN Act has other qualifications and exceptions, which the practitioner should examine before determining whether Home Away must give the 60 days' advance notice.

10 You should have seen this one coming.

estate. The Act doesn't explicitly say that a bank that acquires all of the declarant's units by a deed in lieu of foreclosure acquires the special declarant rights.

Mr. O'Reilly doesn't have the WARN Act and employee problems of our previous example that Home Management had to deal with. He does, however, have troubles of his own.

For example, Basil Development may be personally liable to the association for the unpaid assessments on its 100 units. As long as Mr. O'Reilly is controlling the association, the association isn't going to pursue the debt, but once B&B takes over the association, the directors chosen by Basil will have to leave the association board, and B&B may go after Basil Development for the past-due assessments.

Conversely, if B&B doesn't pay attention to the assessments, or lets the 20 purchasers elect some new board members, B&B may be shocked when the association forecloses its lien on the 100 repossessed units and asserts that its lien is superior to B&B's interest.

When you're advising Mr. O'Reilly, look through your state's condominium statute. Start with the warranties required by law. In Oregon,[11] for example, the developer of a new condominium must warrant a unit and its limited common elements for at least one year from the delivery of possession of that unit "to the first unit owner other than the declarant." ORS 100.185(1)(a). So the deed in lieu from Basil to B&B will start the clock on Basil's one-year warranty of the components of that unit. If B&B takes five months to sell the unit to an actual consumer, that consumer will have only seven months left of Basil's statutory warranty on the unit.

California[12] requires a builder to be liable to a claimant for certain construction defects for ten years from close of escrow, for plumbing and electrical defects for four years, Cal. Civ. Code §896, and for fit-and-finish defects for one year, Cal. Civ. Code §900. "Claimant" is defined to include "individual unit owners of attached dwellings and, in the case of a common interest development," the owners' association. Cal. Civ. Code §895. "Close of escrow" is defined to be the date of the close of escrow between the builder and the original homeowner, or, for claims by an owners' association, the later of (a) the date of substantial completion and (b) the date the builder relinquishes control over the association's ability to decide whether to sue. If the Failte Towers are indeed faulty, for how long after the giveback will Basil be potentially liable to the people who eventually purchase the units from B&B, given that there will never be a close of escrow between the builder and the people we would think of as the original homeowners for the remaining 100 units? You can't terminate this liability, but your client will want to know what it is before giving up control of the property and the association.

Even if Basil can't avoid being liable to future unit owners for construction defects, consider what, if anything, Basil will warrant to the bank, and whether you're agreeing that the bank can assign those warranties to future unit owners.

III. Representations and Warranties

A lender that accepts a property in lieu of foreclosure will want to make a written agreement with the borrower that sets out the terms on which the lender's accepting the property. The lender will want the borrower to give representations and warranties about the property. Here are some

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11 Oregon has not enacted the Uniform Condominium Act.

12 California has not enacted the Uniform Condominium Act.

representations and warranties that our office has seen in deed-in-lieu agreements proposed by lenders, with my thoughts on how to evaluate them before your client signs the agreement:

> **Solvency.** None of Borrower or Guarantor is insolvent and none thereof will be rendered insolvent as a result of the transactions provided for in this Agreement.

Comment: The lender wants a representation that the borrower and guarantor are not making a fraudulent transfer that their other creditors might seek to reverse. If the borrower is a single-asset entity, it might already be insolvent – the debt on the property might exceed its fair value and the borrower might not have enough other assets to cover the shortfall – and the borrower should change this representation to something that is true, possibly by shortening this to read that "Neither Borrower nor Guarantor will be rendered insolvent as a result of the transactions provided for in this Agreement."

> **Value of Property.** The sum of the fair market value of the Property and the amount of the Borrower's Payment [money that the borrower pays the lender when the borrower gives the property back] does not exceed the Loan Balance stated above. Borrower and Guarantor have concluded that the Property is not economically viable with its current level of indebtedness.

Comment: The borrower and guarantor should be willing to make this representation; they're saying that the property isn't worth what is owed on it. The lender wants the borrower and guarantor to agree that the lender isn't getting a preferential transfer.

> **Confirmation.** The recitals to this Agreement are true and correct. The Loan Documents are in full force and effect. The Foreclosure has been validly instituted and conducted to date and is currently pending as described above. Neither Borrower nor Guarantor has any defense of any nature whatsoever to the Default, the Foreclosure or the acceleration by Lender of all indebtedness under the Loan Documents, nor shall this Agreement or the transactions contemplated by this Agreement give rise to any such defense.

Comment: The lender doesn't want the borrower and guarantor to come back later, when the property is repainted, recarpeted, and retenanted (and worth much more), to argue that the borrower gave the property back under the duress of an improper foreclosure.

> **Condition of Property.** To the best knowledge of Borrower and Guarantor, there are no material defects in, nor has any material damage (that has not been fully repaired) occurred in or to, the Property, including all improvements, building systems and utility facilities thereon.

Comment: If the first three representations turn out to be false, third parties might challenge the transaction, but if no one else challenges the transaction, the lender won't have any claim against the borrower or guarantor. This representation and those that follow are different: if they are false, the lender may have a claim against the borrower and guarantor. Discuss these with your client carefully before they agree to give these representations and warranties.

> **Disclosure.** Borrower and Guarantor have disclosed to Lender all facts and information known to them that are material to the Property or the transactions contemplated by this Agreement, including any adverse facts or information.

Comment: Make sure your client understands how broad this is.

Existing Agreements. Exhibit 1 attached to this Agreement contains a complete list of all contracts, arrangements, obligations, agreements or commitments relating to the Property and all amendments thereto (collectively, the "Contracts"), other than the Permissible Exceptions and the "Leases" (as hereinafter defined). Exhibit 2 attached to this Agreement is a true, accurate and complete rent roll and summary of all leases and other agreements for the use or occupancy of the Property, and all assignments, subleases and amendments thereto (collectively, the "Leases"), together with a list of all tenant security deposits, prepaid rent and other deposits and prepayments thereunder (collectively, the "Tenant Deposits"). Except as otherwise disclosed in Exhibit 1 (as to Contracts), Exhibit 2 (as to Leases) or the Title Report (as to Permissible Exceptions), respectively: (a) no default has occurred, and no event has occurred that with notice or lapse of time or both would constitute a default, under any of the Contracts, Leases or (except for the Default) Permissible Exceptions; (b) none of the Contracts, Leases or Permissible Exceptions has been amended or modified; (c) each of the Contracts, Leases and Permissible Exceptions is in full force and effect; (d) Borrower has not assigned or granted a security interest in any of the Contracts, Leases or Permissible Exceptions to any person or entity other than Lender, and Borrower's interests therein are not subject to any lien, encumbrance, claim, setoff or deduction; (e) the term of each Lease and the obligation to pay rent thereunder has commenced and the tenant thereunder is in full possession and occupancy; and (f) no person or entity has any right to occupy or use the Property or any portion thereof.

Legal Requirements. Neither the Property nor Borrower's use thereof violates any applicable covenant, condition, restriction, easement, license, statute, ordinance, regulation, order, permit, rule, agreement or law, including without limitation any building, zoning, health or environmental restriction or governmental requirement (collectively, the "Legal Requirements"). Neither Borrower nor Guarantor, nor any officer, director, shareholder, partner, member, manager, employee, independent contractor or agent of Borrower or Guarantor, has received any notice of the existence of any violation or alleged violation of any of the Legal Requirements, and neither Borrower nor Guarantor has any knowledge of any such notice or violation occurring during or before its ownership of any of the Property that has not been fully corrected with all related fines and penalties paid and discharged in full.

Comment: This should not be a big issue for Failte Towers, which is new construction and likely has a full set of permits and land use approvals, but the first sentence may be a big issue for Retail Valley and Metro Suite. The borrower may not know exactly what every tenant is doing, and whether it's legal. Tenants do sometimes alter their spaces without getting proper permits, and they sometimes change their uses in a way that violates the zoning code. Does "Borrower's use" include all the uses of Borrower's tenants? Ask to limit the first sentence to say that the borrower has no actual knowledge that any tenant's use violates laws or restrictions.

Tax Strategies for Distressed Real Estate – Who Said Taxes Are A Certainty?

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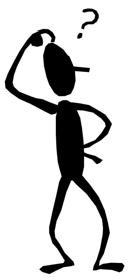
Taxes



- Goals:
  - Eliminate Federal, State, and Local Tax Liability
    - Income Tax
    - Transfer Tax
  - Preserve Tax Attributes (*e.g.*, not operating loss (NOL) carryovers)

1

Bankruptcy v. Non-Bankruptcy

- Tax considerations
  - Cancellation of indebtedness ("COD") income, ways to eliminate income "hit" & repercussions
  - NOLs and Section 382
  - Dealing with tax audits
  - Transfer Tax Exemptions

2

Troubled Company: Can It Still Claim an Interest Deduction on Its Debt?

- Distinction between secured and unsecured debt
- Distinction between bankruptcy and non-bankruptcy
- Split in cases

3

Lender to Troubled Company: Must It Continue to Accrue Interest Income?

- Stop accruing interest when it become clear that interest will not be paid.
- Insolvency the key?
  - Rev. Rul. 80-361-says yes!

4

Tax Issue: Cancellation of Indebtedness Income

- Generates ordinary income
- General Rule -
  - Owe $ 100
  - Pay back 80
  - Income $ 20

5

If you avoid losing your property, are you tax wise OK

- You agree to MODIFY the terms of your debt instrument to stay alive.
- What happens?

6

Modifying Debt Obligations

- Debt that is significantly modified is treated as “exchanged” for old debt
  - This can have a significant tax impact (unless it can be a tax-free recap, which is hard to assert)

7

What tax impact????

- If the issue price of “new” debt is different from “adjusted issue price” of old debt, then tax consequences can ensue.
- In particular, this can happen where:
  - Vulture capitalist bought debt at a discount
  - Company may have written down some of the debt
  - Value of Company has fallen

8

Example

- Buyer acquires creditor's position in a $100M Note for $60M
- After purchase, buyer renegotiates terms of debt by dropping interest rate by 100 points
- Taxable exchange of Old Debt for New Debt
- Buyer's Realized Gain = $40M <u>but</u> installment sale <u>but</u> interest charge
- <u>Borrower</u>: Possible COD Income

9

Cancellation of Indebtedness?

- Tax law provides that old debt is "deemed" satisfied by money equal to issue price of new debt. There is COD if new "issue price" is less than redemption price of old debt.
- <u>Key</u>: Different rules for nonpublicly traded debt and publicly traded debt.
  - Publicly traded debt presents a problem!

10

Non Publicly Traded Debt

- Tax law provides that "issue price" is stated principal amount assuming adequate stated interest and not potentially abusive situation.
  - Adequate stated interest must at least equal the "applicable federal rate" or AFR.

11

Non Publicly Traded Debt (cont.)

- In potentially abusive situation, issue price is "fair market value" of the new debt instrument.

12

Non Publicly Traded Debt (cont.)

- Potentially abusive situation is
  - (i) a "tax shelter";and
  - (ii) any other situation which, by reason of –
    - (I) recent sales transactions,
    - (II) nonrecourse financing,
    - (III) financing with a term in excess of the useful life of the property, or
    - (IV) other circumstances, is of a type which the Secretary specifies by regulations as having potential for tax avoidance

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Non Publicly Traded Debt (cont.)

- "Tax Shelter" is:
  - (I) a partnership or other entity,
  - (II) any investment plan or arrangement, or
  - (III) any other plan or arrangement "***if the significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.***"

14

Publicly Traded Debt

- Issue price if either the retired debt or the newly issued debt is "publicly traded" is "fair market value"
  - This can trigger COD!

15

Publicly Traded Debt

- Debt is publicly traded if it is "traded on an established market".
- Current Regs treat debt as traded if it is traded at any time during 60 day period ending 30 days after issue date

16

Publicly Traded Debt

- Exchange traded – national securities exchange, interdealer quotation system sponsored by a national securities association or certain foreign exchanges (e.g., the London Stock Exchange)
- Interbank Market or contract market such as CFTC
- Quotation Medium – "system of general circulation" that provides a reasonable basis to determine fair market value by disseminating either recent price quotations of one or more identified brokers, dealers or traders or actual prices of recent sales transactions (only of part of an issue > $25 Million)

17

Publicly Traded Debt (Proposed Regulations)

- Proposed Regulations issued January 6, 2011 expand and clarify the definition of "publicly traded".
- The preamble to the proposed regulations states that the IRS and Treasury feel that the phrase "traded on an established exchange" for purposes of setting a debt instrument's issue price is ***intended to be interpreted broadly***.

18

Publicly Traded Debt (Proposed Regulations continued)

- "Publicly traded" includes debt or property for which a sales price for a recently executed purchase or sale is available,
- debt or property for which it is possible to get a firm quote from a broker, dealer or pricing service for the property or substantially similar property, or
- debt or property for which an indicative quote is available from at least one broker, dealer or pricing service

19

Publicly Traded Debt (Proposed Regulations continued)

- There is an overall *de minimis* trading exception if within a 31-day period ending 15 days after the issue date all sales of the debt instrument are for increments of $1 million or less and all such sales aggregate to $5 million or less.
- There is an anti-abuse rule if there is any temporary restriction on trading, a purpose of which is to avoid the characterization of property as one that is traded on an established market.
- There is also a small issuance exception for debt instruments in which the issue does not exceed $50 million

20

Publicly Traded Debt (Proposed Regulations continued)

- The practical effect of the expansion of "publicly traded" is more COD for the borrowers, and less gain on a deemed modification for purchasers of distressed debt.
- Borrowers who have COD will have OID on the new deemed issue subject to AHYDO rules (for corporate taxpayers and debt > $5 million)

21

REMIC Qualification Concerns

- Securitized commercial real estate loans are typically owned by a REMIC.
- REMIC – Real Estate Mortgage Investment Conduit
- REMICs are generally not permitted to dispose of mortgages
  - Dispositions can impact REMIC treatment and can be a 100% prohibited transaction tax.

22

REMIC Qualification Concerns (cont.)

- Significant Modification treated as a disposition
- This can inhibit ability to work out debt held by REMICs.
- The 2009 Final Regulations and Revenue Procedure 2009-45 permit certain types of modifications without jeopardizing REMIC qualification if the modification is in connection with a reasonably forseeable default.

23

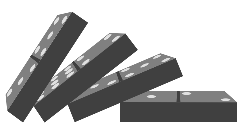
Lesson to be learned

- Modify debt <u>BEFORE</u> you acquire it!
- After acquisition, just sit with it!

24

What is a modification?

- Anything=modification
- Significant modification=legal rights & obligations that are altered & economic degree to which they are changed is significant
- Nearly anything=significant



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Significant modification

- Facts and circumstances test - "Significant" modification is a subjective test <u>BUT</u> objective benchmarks are created!
- Change in principal
- Change in maturity date
  - Safe harbor if less than 5 years or 50% of original term
  - Consider effect on yield

26

Modifying Debt Obligations (con't)

- Change in interest rate
  - 25 basis points
  - original terms exception
  - Consider impact if get a fee
- Change in obligor
  - OK if non-recourse
  - If recourse obligation, answer depends on form of transaction and effect on payment expectations
- Original terms exception

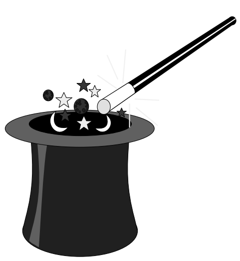
27

Modifying Debt Obligations (con't)

- Changes pursuant to terms of original instrument generally are not modifications
- For example, allows for substitution of collateral (as long as you do not go from recourse to non-recourse or vice versa)
- But may not always work (such as for a change in obligor)

28

Planning



- Any ways to make COD go away?

29

Two Basic Rules to Keep in Mind

- Debt reduction is ordinary income, that is, COD income
  - Regardless of whether debt is recourse or nonrecourse
- By contrast, sale of property subject to debt "generally" generates capital gain
  - Debt balance is part of amount realized
  - <u>But</u> could generate a tax loss!

30

Foreclosure

- If debt is "recourse" then
  - Property is treated as--
    - Sold for its FMV (generating potential capital gain)
    - Excess of debt over FMV is COD income
- If debt is "nonrecourse" then
  - Property is treated as sold for amount of the debt
  - FMV is irrelevant!

31

Foreclosure Example

- Debt = $1,000x
- FMV = $800x
- AB = $300x
- Foreclosure IF nonrecourse debt--
  - Property sale-Gain=$700x ($1,000x-$300x)
- Foreclosure IF recourse debt--
  - Property sale-Gain=$500x; COD=$200x

32

Recourse v. Nonrecourse

- Not exactly clear in the context of a pass through entity for COD purposes!
- More on this Later.

33

Transfers to Eliminate COD?

- To corporation----
  - Problem-trigger gain recognition
- To partnership---
  - No gain recognition BUT tracking rules charge back future COD to contributing partner
  - Assignment of income principles can also apply

34

Quirky Holding Period Problem for PS Interest

- Example: ABCD PS, formed five years ago, is in trouble. A, B, C and D each contribute $50K to help the PS out. Six months later, they dispose of their interest in the PS.
- Issue: What is their holding period? Tax law surprise – they have two holding periods, which can be a tax negative factor.

35

Like kind exchanges

- Can Section 1031 come to the rescue?
- Buyer acquires the property by assuming the liability or taking subject to the debt
- Debtor then receives replacement property encumbered by the same or more debt and with some level of additional investment
- What result?

36

Like kind exchanges

- **Can a 1031 exchange be accomplished without the cooperation of the lender?**
- **Can a judgment in foreclosure be assigned to a qualified intermediary?**
  - **There may be restrictions on assignment in the mortgage which can trigger recourse guarantees**
  - **Can you assign rights under mortgage pursuant to which the property is transferred?**

37

COD Income Exceptions

1) Purchase price Adjustment
   - Must be original buyer and seller
2) Contribution to capital by shareholder
   - Beware-only works to extent of shareholder 's basis in the debt
   - S Corp--Special Rule
3) Contribution to Partnership – see later discussion
4) Qualified Farm Debt

38

Insolvency Exception

- No income recognized <u>BUT</u> only to extent of insolvency, which means excess of liabilities over FMV of property
- Exception for nonrecourse debt being discharged
- Include assets exempt under state law
- <u>PROBLEM</u>-Factual determination!

39

Insolvency Example

- **S Corp has Debt = $120**
- **FMV of its assets = $100**
- **What happens if cancel $30 of debt?**
- **Insolvency = only $20.**
- **Recognize $10 of COD Income!**
- **<u>Query</u>: What happens if this is a LLC?**

40

Bankruptcy Exception

- **No COD <u>BUT</u> must be discharged by court order pursuant to the plan**
- **Do not worry about solvency of debtor so even works in a chapter 11 reorganization where there can be real value**
- **Powerful tool!!!**
- **<u>Query</u>: What happens if the entity is a LLC?**
- **Declaring Bankruptcy can trigger "Bad Boy" carve out guarantees.**

41

Price for Insolvency/Bankruptcy Exception

- Attribute reduction at the end of the year & after tax liability for that year is determined-Planning!
- Attribute reduction-ordering rules!
  - Elective basis reduction first
  - NOLS
  - Certain tax credits
  - Capital losses
  - Basis of property
  - PAL carryforwards
  - Other tax credits

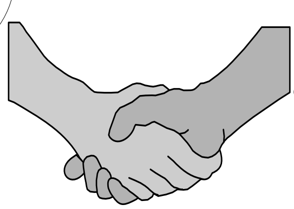
42

If COD exceeds Attributes

- **If COD exceeds attributes, "generally" no problem**
- **Beware consolidated tax group with ELA can cause mischief**

43

Related party debt acquisition



- Can you avoid COD by having a related party buy the debt?
- Tax law blocks some, but not all, planning options.

44

"Related party" debt acquisition can produce COD

- Generally not considered related if less than 50% overlapping ownership (capital or profits but not voting rights)
- Relatedness is determined under tax rules with a modified definition of "family" (siblings not related) and a special rule for entities treated as a single employer under section 414.

45

Related party debt acquisition (cont.)

- The debt may be acquired directly by a related person or "indirectly" in a transaction in which a holder of the debt becomes related to the debtor after having acquired the debt in anticipation of becoming related to the debtor.

46

Related party debt acquisition (cont.)

- Whether debt acquired in "anticipation of becoming related" is based upon facts and circumstances:
  - Debt is conclusively presumed to be acquired in anticipation of becoming related to the debtor if the holder of the debt acquired the debt less than six months before becoming related to the debtor.
  - If parties become related more than 6 months after the acquisition but less than 24 months, debtor must report "relationship" to IRS with statement attached to return. Disclosure also required if debt > 25% of FMV of assets of purchaser.

47

Section 108(i) – expired

- Code section added by American Recovery and Reinvestment Act
- Special COD deferral rule for 2009 and 2010 only
- For these two years only, debtors may have elected to defer COD arising from a "reacquisition" of an "applicable debt instrument" occurring in 2009 and 2010

48

Section 108(i) (continued)

- The Deferral Regime
  - Cancellation of debt is deferred until 2014, at which point debtor includes COD into income ratably over five-year period (i.e., 2014-2018)

49

Section 108(i): Special Rules

- Immediate recognition of deferred COD will occur if:
  1. the debtor liquidates or sells substantially all of its assets (including in a chapter 11 or similar case),
  2. ceases to do business, or
  3. for partnership debtors, acceleration also occurs upon sale of an interest in the partnership

50

Section 108(i): Special rules (continued)

- If election to defer is made, COD from that debt cannot later be excluded from income under insolvency or bankruptcy exception (or any of the other exceptions)

51

Real estate

- Any special breaks?

52

Qualified Real Property Business Indebtedness

- Special COD Exclusion
- Applies to all except for C corporations
- Debt to acquire real property used in a trade or business AND is secured by realty
- Exclusion = Princ. amt. of debt - FMV
- But exclusion not in excess of AB of <u>depreciable</u> real property

53

Requirements

- What is needed to take advantage of this tax break?

54

#1-Election

- Must file an election to get the benefits
- C corporations cannot make the election
- Partnerships do not make the election but their partners can (unless they are C corps)
- Cannot elect if insolvent!
- Elect on a property by property basis

55

#2-Eligible Real Estate

- Real property used in a trade or business
- Investment real estate does not count
- Triple net leased property? Yes.
- Dealer property?
- Raw land?
- Raw land with a leased billboard?

56

#3-Security

- Debt must secure the property!
- Unsecured debt will not work!
- Query: Does a pledge of shares in a coop satisfy this test?
- Query: Single member LLC and you pledge all the interests in the LLC--is that adequate enough?

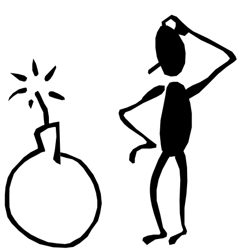
57

#4-Qualified Acquisition Debt

- Debt incurred to acquire, construct, reconstruct or "substantially" improve real estate OR
- Debt used to refinance such debt OR
- Pre-1993 debt
- Debt used to cash out does not count!
- Farm debt-not applicable

58

Any limitations?



- Let's take a look:

59

Limitation #1-FMV Limitation

- "Property specific insolvency test"
- Exclusion is limited to the
  - EXCESS of the outstanding principal amount of the debt
  - LESS the "*net* FMV" of the property, that is, FMV as REDUCED by other QRPBI secured by the property that is *not* being discharged

60

Example

- Debt = $100M
- AB = $30M
- FMV = $80M
- Goal: Reduce debt to $70M
- Result: Exclusion only applies for $20M (that is, $100M less $80M)

61

Example-2 Mortgages

- 1st Mort. = $100M; 2d Mort. =$15M
- AB = $30M
- FMV = $80M
- Goal: Reduce 1st Mort. to $70M
- Limitation=Excess of Debt over "net FMV"
- Result: Exclude full $30M (that is, $35M limit, $100M - ($80M less $15M) or $100M-$65M)

62

What is “outstanding principal amount”?

- Is accrued but unpaid interest included in “outstanding principal amount”
- Yes!

63

#2-Basis Limitation

- Exclusion cannot exceed the AGGREGATE basis of “depreciable real property” held by the taxpayer immediately before the discharge
- Anti-stuffing rule: Do not count property acquired in contemplation of the discharge.
- Adjust further for depreciation claimed in that year for affected property

64

Example

- Debt = $100M
- AB = $10M
- FMV = $80M
- <u>Goal</u>: Reduce debt to $80M
- <u>Problem</u>: If this is your only depreciable RE then only get exclusion for $10!

65

#3-Price to pay for QRPBI Exclusion

- Basis reduction on first day of next year BUT
- basis reduction accelerated if property is sold by year end
- What properties are affected?
  - First, property for which exclusion is claimed,
  - Then, all other properties.
  - Multiple properties-allocate in accord with AB

66

Added Price to Pay

- Basis reduction is deemed to be attributable to depreciation deductions.
- Result: Recapture income is taxed as ordinary income
- But: Recapture income declines over time

67

#4-Partnerships in PS

- Special tax rules apply

68

Partnerships & Workouts

- Subchapter K (*i.e.*, special partnership tax rules) and COD rules not well coordinated
- Entity v. aggregate theory
- Let's take a look at what happens here:

69

The Troubled Partnership

- When the partnership realizes a discharge of indebtedness, there are two sets of rules that are relevant:
  - COD
  - Subchapter K
- Partnership realizes COD
  - COD passes through to each partner (generally)
  - Partner level determinations of any exclusions

70

The Troubled Partnership (con't)

- Whether or not the partnership is bankrupt or insolvent is usually irrelevant
- Timing of COD
  - recognition on last day of partnership's years
- Basis rules
  - reduction of liability = deemed distribution of money

71

Partnership COD: "Recourse v. Nonrecourse" Distinction

- In a sale or foreclosure, different consequences can apply depending upon whether debt is "recourse" or "nonrecourse"
- How is this determination made if indebtedness is "recourse" to all of partnership's assets but as to which some or all of partners have no personal liability?
- There are two views:

72

Partnership COD: "Recourse v. Nonrecourse" Distinction

- View 1 – Make determination at partnership level so that if lender can proceed against all partnership assets, debt is recourse
- View 2 – Make determination at partner level by applying 752 regs.
  - Great Plains Gasification, 92 TCM 534 (2006) provides some support for view 2.

73

Bankruptcy Court has Jurisdiction over Partnership but not Partner

- Legislative history of 1980 BTA assumes partner gets benefit of exclusion for discharge of PS debt so long as partner is subject of bankruptcy case (even if not partnership's case). S. Rep. 96-1035 at 21 (1980).
- Price decision (TC Memo 2004-149) gave partner benefit of exclusion even though not in his own title 11 case, where bankruptcy court granted him discharge in PS's title 11 case.

74

Subchapter K Rules Triggered by Partnership COD?

- Section 731 Gain due to Section 752 deemed distributions
- Section 704(b) Allocation of COD Income
  - Minimum Gain Chargeback (if the debt is non-recourse debt) or Partner Nonrecourse Debt Minimum Gain Chargeback (if the debt is partner non-recourse debt)
  - Substantial Economic Effect

75

Partnership COD Allocation

- How is COD allocated?
  - As partners shared debt.
- Are capital accounts then out of line?
  - Permissible to "book down" under regs
- Can you specially allocate COD income to insolvent partners?
  - Is there substantial economic effect? See RR 99-43.

76

Rev Rul 99-43

- A & B form PS
- A & B each contribute $1K
- PS borrows $8K nonrecourse & buys a $10K property
- Workout: FMV drops to $6K & lender agrees to reduce debt to $6K.
- A puts in $500 of expenses to pay workout expenses

77

Rev Rul 99-43 (cont)

- A and B agree to:
  - Allocate $500 to A;
  - Allocate $2K of COD to "insolvent" B;
  - Book loss of $1K to A & $3K to B; &
  - Future income & loss 60% to A & 40% to B
- Held: Special allocation to B lacks substantial economic effect

78

Partnership Workouts Involving Cash Additions to Partnership Equity

- New partner admitted to debtor partnership for cash capital contribution.
  - Minimum gain considerations
  - Section 752 liability shift considerations (current and future) even if new equity is not used to pay down debt.
  - Special considerations if new partner related to lender.
- Formation of subpartnership between existing partnership and new partner.
  - Does Section 721 apply to the transfer of property with no equity value?
  - What are the consequences of Section 752 (c) mandating that the amount by which the liability exceeds FMV is not treated as debt of the subpartnership?

79

Adding a new member

- Great for the economic health of the PS
- BUT, beware of Section 752
  - Constructive distribution can occur!

80

Debt for Equity Transactions

- Partnership is treated as satisfying debt with amount of money equal to FMV of partnership interest.
  - Contribution of debt for partnership interest should ordinarily qualify under Section 721 as contribution of "property" but query if debt was originally issued in consideration of services (rather than property or money).

81

Any other concerns:

- Employment taxes-What happens if they get diverted to cover costs?

82

Avoiding Liability for Employment Taxes

- "Trust fund" taxes in general
- Section 6672
  - responsible person
  - willfully failed

83

Avoiding Liability for Employment Taxes (con't)

- Who is at risk?
  - officers
  - employees who can sign checks
  - owner-employees
  - financial institutions

84

Avoiding Liability for Employment Taxes (con't)

- Designation of payments allowed
- Bankruptcy court may designate as well

85

Anything else?

- Let's take a look at other things that can affect a workout!

86

Real Property Transfer Taxes

- Can be very significant
- Bankruptcy Code § 1146 exclusion may be helpful to eliminate tax burden

87

Corporate Limitations - Section 382

- Annual limitation on corporate net operating loss deductions
- Applies if:
  - More than <u>50%</u> increase in
  - Value of company's stock
  - Owned by "5% shareholders"
  - over 3-year period

88

Section 382 (con't)

- Limitation =
  - Value of company before change (generally)
  - Multiplied by long-term tax-exempt rate
- Value of company reduced by:
  - capital contributions within 2 years (or longer)
  - related redemptions
  - non-business assets if they represent more than 33%

89

Section 382 (con't)

- Continuity of business enterprise test
- Built-in gains <u>increase</u> limitation
- Built-in losses <u>reduce</u> limitation

90

Section 382 (con't)

- Special rules for bankrupt corporations
  - 382(l)(6) -- value of company reflects <u>increase</u> from debt reduction
  - 382(l)(5) -- if <u>historic</u> shareholders and creditors own at least 50% of vote and value upon execution of the plan, then no limitation, but NOL reduced by: (a) interest deductions within 3 years for debt exchanged for stock, and (b) in some cases other items

91

Section 382 (con't)

- Worthless stock deduction
- <u>Prudential Lines</u>, 107 B.R. 832 (Bankr. D. N.Y. 1989)

92

Section 382 (con't)

- Constructive ownership
  - Entity attribution
  - Family attribution
  - Option attribution
    - "Ownership" purpose
    - "Control" purpose
    - "Income" test

93

Using NOLs

- Buying assets of profitable company
  - If taxable transaction, Section 269 does not apply
- Buying stock of profitable company
  - Section 269?
  - Section 338

94

Using NOLs (con't)

- Alternative minimum tax
- Section 384
  - Limitation on use of pre-acquisition losses to offset built in gain
  - Applies to purchase of control of corp or asset acquisition in a tax free manner

95

Section 269

- Tax avoidance as the principal purpose
- "Control" = 50% vote or value
- Treas. Reg. § 1.269-3
  - bad purpose presumed in certain § 382(l)(5) cases

96

"G" Reorganizations

- Only available in bankruptcy
- Simpler than "A" variations
  - no merger required
- Simpler than a "C"
  - no "solely for voting stock" requirement
  - softer "substantially all the assets" test?

97

Consolidated Return Issues

- Use of group losses
- Excess loss accounts
- Inter-company transactions
  - COD
  - DIT

98

Impact from Foreign Persons Investing in the Deal

- Do the same tax consequences apply to foreign persons who are either owner/debtors or lenders?
  - As a first step, the answer is yes.
  - But additional steps are required to comply with foreign tax provisions of U.S.
- The additional steps include the following considerations:

99

Owner/Debtor's Perspective - Questions

- Can the foreign owner avoid tax on gain on foreclosure of triple net leased property?
- Is such gain ordinary income or capital gains?
- Is a loss on foreclosure transfer usable under U.S. tax law?
- Is COD business income subject to graduated rates or a flat rate (but eligible for treaty relief)?
- If COD is income subject to graduated rates, can the foreign debtor claim Section 108 exemptions and deferrals?
- What if COD is subject to flat rate.
- What about currency exchange gains from the debt discharge?

100

Foreign Lender's Perspective - Questions

- Can the foreign lender claim a bad debt deduction?
- What about a taxable loss on sale of distressed debt?
- If the lender is a secondary purchaser of the distressed debt, can it avoid recognizing gain on a workout modification under the "trading in securities" rule?
- And would the "trading in securities" rule protect the secondary debt purchaser from recognizing gain on sale of the security?

101

Dealing with the Foreign Person - Questions

- Are there any additional considerations for a U.S. investor on the other side of the foreign investor?
  - Special 10 percent FIRPTA withholding imposed on purchaser of foreign person's realty.
  - Potential 30 percent withholding on COD amount imposed on lender to the foreign owner/debtor in a workout, unless reduced by treaty.

102

Foreign Original Lender and Foreign Secondary Lender

- Upon foreclosure, foreign lender becomes an owner subject to FIRPTA.
- COD partial write-off of mortgage by original lender (assuming it is a corporation) should be treated as bad debt, eligible to reduce other U.S. business income.

103

What Else Does the U.S. Person Need to Know if His Lender or Borrower is Foreign?

- Withholding, withholding, withholding!
- U.S. mortgage lender seeks to foreclose. FIRPTA imposes a 10% withholding obligation on the transferee for value of real estate from a foreign transferor.
  - In the absence of special rules, the mortgage lender would have to turn over 10% of the amount of the debt outstanding (the amount realized by the foreign owner) to the IRS. But the mortgage lender has no proceeds from the owner to pay such tax (other than the very illiquid distressed realty). Special exemption for mortgage lenders exists.
    - Note – This does not reduce foreign owner's obligation to pay tax on the gain.

104

Tax Exempt Investors

- Are taxable on "unrelated business taxable income"
- UBIT concerns can arise if foreclose on mortgage and acquire property

105

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GIVING BACK THE KEYS: DEEDS IN LIEU OF FORECLOSURE

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Attorney at Law

What's in it for lenders?

- Has the potential to reduce negative publicity, which can adversely affect market value
- Can (but doesn't always) reduce costs
- Allows lenders to obtain their borrowers' cooperation, which can make the transition more orderly and, therefore, reduce losses
- Gives lenders a way to clean up potential documentation inadequacies

Why shouldn't lenders agree to it?

- A deed in lieu does not extinguish junior liens and encumbrances
- In some states, it can be faster and less costly to foreclose than to go through the due diligence and negotiations associated with a deed in lieu
- If the borrower/counsel on the other side are inexperienced, this can turn into a very difficult, time consuming and expensive process
- Deficiency judgment considerations

Due Diligence Considerations

- Examine the borrower's authority
- Obtain a recent, detailed statement showing the borrower's financial condition
- Obtain an estoppel affidavit from the borrower to verify solvency
  - Single asset borrowing entities seeking to return properties are often insolvent. Even under these circumstances, the lender should not be subject to a preferential transfer or fraudulent conveyance challenge if the lender has established that the debtor has no equity in the property and the transaction was not fraudulent or collusive

Due Diligence, ctd.

- Environmental testing
  - The borrower's liability for environmental issues should arise upon discovery of an unacceptable environmental condition, not upon realization of a loss
- The lender should obtain an owner's title insurance policy effective on the date of the conveyance
- Independent appraisal
  - establishes adequacy of consideration
  - establishes that the conveyance is not being made for less than a reasonably equivalent value while the borrower is insolvent or undercapitalized

Due Diligence, ctd.

- Copies of all books and records reflecting the management of the property
- Leases and rent rolls
  - Are leases assignable? Do they terminate upon foreclosure/deed in lieu?
- Contracts and management agreements
- Existing environmental reports and surveys
- ADA compliance and other engineering reports

Essential elements

- Borrower's authorization to enter into the transaction
- Ratification and confirmation of loan obligations
- All financial information submitted by the obligors to the lender is true and correct
- The transaction does not render the borrower insolvent. The borrower does not intend to hinder, delay or defraud any of its creditors
- All obligations of the borrower associated with the property are listed

Essential elements, ctd.

- Environmental indemnity
- Property insurance is still in place
- All brokerage, listing, management, service, equipment, supply, security, maintenance and other agreements that affect the property are listed
- All the leases, subleases, licenses, concession agreements are listed
- Security deposits and pre-paid rent
- Status of real estate taxes is shown

Essential elements, ctd.

- No notice of any pending condemnation or threatened rezoning
- No notice or knowledge of any other violations of any statute, law or ordinance
- Any reserve/escrow account maintained by the lender in connection with the loan can be retained by the lender and applied against the loan
- Closing cost allocations

Essential elements, ctd.

- Covenant not to sue, provided obligors strictly comply with the terms of the settlement agreement and no court determines that the transfer constitutes a preference of a fraudulent conveyance
  - The settlement agreement and the deed should not state that the mortgage debt is canceled or extinguished

Essential elements, ctd.

- All obligors absolutely and irrevocably release and waive any claims against the lender, any future property purchaser and related parties. This provision survives the closing or earlier termination of the settlement agreement
- If the borrower is given the right to continue to manage the property, the lender should have the right to terminate the management duties at any time
  - The borrower's management duties, if any, should never include the ability to control the development or sale of the property

No Merger

- Generally, when one party holds both record title to property and a mortgage thereon, the legal interests merge and the mortgage ceases to be an encumbrance
- A merger between the deed in lieu and the mortgage can cause the lender to lose the ability to subsequently foreclose on the property to extinguish junior liens and other encumbrances

No Merger, ctd.

- Unless prohibited by state law, the loan documents continue in full force and effect and remain as a first priority lien against the property
  - preserves the lender's lien priority if mechanics' liens and/or other junior encumbrances are discovered
  - protects the lender if the deed is later set aside
  - Note: in some states a merger may occur regardless of the intention of the parties

No Merger, ctd.

- Do not release the mortgage until the property is subsequently sold
- The lender retains the right to foreclose
- The borrower's conveyance is absolute and is not intended as a mortgage, trust conveyance, deed of trust or security instrument of any kind
  - Failure to do this exposes the lender to the risk that the conveyance can be recharacterized as an equitable mortgage

Title Insurance

- Explore whether you can obtain a non-merger title insurance endorsement in your state
- Effective March 8, 2010 the American Land Title Association withdrew its creditors' rights endorsement
  - Creditors' rights endorsements have never been available in Florida, New Mexico, New York or Texas
  - Title companies felt that the issue of the borrower's financial viability or the issue of proper consideration being paid is not a title matter that an insurer can properly assess by examining public records