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Foreclosures and Bad Boy Guarantees: Just How Bad is Bad?

Real Estate and Business Litigation Briefing Series

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Why Foreclosures Are Important?
The Current Financial Crisis

"The six biggest U.S. banks, led by JPMorgan Chase & Co. (JPM) and Bank of America Corp., have piled up <u>**$103 billion**</u> in legal costs since the financial crisis, more than all dividends paid to shareholders in the past five years."

- Bloomberg (August 28, 2013)

Outline of Program

1. Background on Foreclosure
2. The Foreclosure Process
3. The Foreclosure Analysis
4. Bad Boy Guarantees and Non-Recourse Carve-Outs

Background on Foreclosure Law: Foreclosure Defined

Foreclosure is the legal process by which a lienholder attempts to recover the balance of an obligation by forcing the sale of the collateral used to secure the obligation

Background on Foreclosure Law

The underlying lien may arise:

1. Voluntarily – The owner of personal or real property pledges the property as collateral for a loan or other obligation
2. Involuntarily – A creditor obtains a lien against a debtor's real or personal property (judgment lien, mechanic's lien, etc.)

Background on Foreclosure Law: Nature of the Obligation

- **Note**: A borrower agrees to borrow money from a lender on certain terms and conditions set forth in a promissory note
- **Security Instrument**: The borrower securitizes its obligation in the form of collateral, the terms of which are set forth in the security instrument (i.e., deed of trust)

Background on Foreclosure Law: Recourse versus Non-Recourse Debt

- **Recourse**: A loan that is secured by the pledge of collateral where the borrower remains liable for any deficiency after foreclosure
- **Non-Recourse**: The lender's remedy upon default is limited to the collateral offered to secure the loan, i.e., the lender has "no recourse" beyond the security

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Background on Foreclosure Law: Personal Guaranty

- A guaranty is a pledge by the borrower's principal or some third party to assume personal liability for the debt
- NOT a form of security
  - Cannot be enforced through foreclosure
  - Exempt from Anti-Deficiency Statutes
  - Exempt from One Action Rule

The Foreclosure Process

- The One-Action Rule
- Non-Judicial Foreclosure
- Judicial Foreclosure

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The Foreclosure Process: The One-Action Rule

- Unlike other states, California requires a lender to foreclose on and exhaust all real property security before obtaining a judgment on the debt
- For this reason, it is also called the "Security First Rule"

The Foreclosure Process: Non-Judicial Foreclosure

- A statutory procedure that allows the lender or the appointed trustee to sell the real property security
- Strict statutory compliance required
  - TIP: Hire a professional trustee service to provide the required notices and conduct the sale

The Foreclosure Process: Non-Judicial Foreclosure

- Advantages:
  - Relatively inexpensive
  - Much faster timeline
    - Approximately four months
- Disadvantages:
  - No deficiency judgment
  - No procedure to appoint a receiver

The Foreclosure Process: Judicial Foreclosure

- A formal judicial proceeding instituted by the lender and supervised by the court
- Strict compliance is not required so long as lender can demonstrate the obligation and the borrower's default

The Foreclosure Process: Judicial Foreclosure

- Advantages:
  - Deficiency judgment
  - Appointment of a Receiver
- Disadvantages:
  - Expensive
  - Time-consuming
    - One year or more

The Foreclosure Process: Choosing The Correct Procedure

- <u>99%</u> of foreclosures in California are Non-Judicial Foreclosures
  - Anti-deficiency statutes undermine the main benefit of assuming the cost and delay of judicial foreclosure
  - As a practical matter, where the borrower has defaulted on its loan, it is unlikely that there are additional assets against which to enforce a deficiency judgment

The Foreclosure Process: Choosing The Correct Procedure

Judicial Foreclosure is advisable only if:

- There will be a deficiency
- Borrower has other significant assets
- There are problems with the transaction's documentation (legal description, no power of sale, problems with chain of custody)
- Real advantage to appointment of receiver

The Foreclosure

- Whether to avoid foreclosure?
- How to navigate an unavoidable foreclosure?

The Foreclosure:
Whether to Avoid Foreclosure?

- Loan Modification
- Short Sale
- Bankruptcy
- Deed in Lieu

The Foreclosure:
Whether to Avoid Foreclosure?

- Loan Modification?
  - Caution: Following a loan modification, a borrower is more than 50% likely to default within six months of modification
  - Tip: When supported by changed circumstances or principal reduction, the modification is far more likely avoid default

-- Office of the Comptroller and Office of Thrift Supervision, 2008

The Foreclosure:
Whether to Avoid Foreclosure?

- Short Sale?
  - **Question**: Is a borrower, who agrees to remain liable for a deficiency as a condition of a short sale, protected by Anti-Deficiency Statutes?
    - **YES** - Public policy dictates these protections non-waivable. *Coker v. JP Morgan Chase Bank*
    - Legislature adds specific statute for short sales.
      - **BUT carve out for corporations, LLC and LPs**

The Foreclosure:
Whether to Avoid Foreclosure?

- Bankruptcy?
  - Automatic Stay
    - May allow the borrower/debtor to avoid or significantly delay an imminent foreclosure
  - Relief of Stay
    - Lender may move the court for relief from the automatic stay upon showing of no equity or "good cause"

The Foreclosure: Whether to Avoid Foreclosure?

- Deed in Lieu?
  - A "wiped out" junior lienholder whose security will be extinguished by the senior lienholder's foreclosure can either:
    - Proceed against the borrower on the now unsecured debt; <u>OR</u>
    - Pay off the arrearage on the senior debt and take a deed in lieu of foreclosure from the borrower

The Foreclosure:
How to Navigate Foreclosure?

Whether from the lender's perspective or the borrower's perspective, the object of foreclosure is loss mitigation. Must consider:

1. Credit worthy guarantor?
2. Value in appointing receiver?
3. Equity in real property security?
4. *** Availability of an enforceable deficiency judgment?**

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The Foreclosure: Revisiting Recourse and Non-Recourse Debt

- Non-Recourse Carve-Outs (aka "Springing Recourse")
  - Non-recourse debt becomes recourse upon occurrence of specified recourse events
    - Traditionally: Fraud; misappropriation; waste; incurring subordinate debt; violation of SPE covenant; and bankruptcy
  - Personal guaranty is also triggered on the full loan amount

The Foreclosure:
Revisiting Recourse and Non-Recourse Debt

Recent Developments:

- In response to the significant deficiencies lenders realized over the past five years, lenders have increasingly expanded the scope of these recourse events to include instances of traditional default
- Courts reviewing these “bad boy” provisions have applied contract principles to uphold them

The Foreclosure:
Revisiting Recourse and Non-Recourse Debt

Example 1: Two Michigan appellate courts upheld non-recourse carve-out provisions and bad boy guarantees that were triggered upon the borrower's "insolvency"

- Although the Court recognized that solvency was not a legal requirement of a single purpose entity, the Court was satisfied that the Note and deed of trust provided that "insolvency" constituted a breach of the SPE covenants

Wells Fargo Bank, NA v. Cherryland Mall Ltd Partnership

51382 Gratiot Ave. Holdings v. Chesterfield Development.

The Foreclosure:
Revisiting Recourse and Non-Recourse Debt

Example 2: Cash Management Practices

- The practice of an owner extending bridge loans to pay project expenses while waiting for construction loan draws to be funded may violate the SPE provisions of a carve-out where owner is repaid after the loan draw funds

Blue Hills Office Park LLC v. J.P. Morgan Chase Bank

The Foreclosure:
Revisiting Recourse and Non-Recourse Debt

- Cause for Comfort?
  - Michigan Legislature expressly rejected post-closing solvency requirement can be grounds for carve-out or bad boy guaranty
  - California Court of Appeal recently declined to hold guarantor personally liable under bad boy provision triggered by tenant's termination
    - Not consistent with "intent" of these provisions
    - No bad act on part of borrower or guarantor

The Foreclosure:
Revisiting Recourse and Non-Recourse Debt

- What can borrowers do?
  - Negotiate with specificity
  - Ensure cash management practice comply with SPE requirements
  - Report practices ***before*** default to preserve waiver and estoppel arguments

Conclusion

- It remains uncertain what California courts are going to do with these expanded non-recourse carve-out provisions. What is certain is that they are not going away any time soon
- Borrowers and lenders should enter into these provisions with an understanding of these risks and negotiate accordingly

Questions?

THANK YOU

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