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Markets Heating Up in the Dog Days of Summer

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A Primer on New York's One Action Rule

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2023 has seen higher levels of real estate loan delinquencies**[1]**. With more headwinds on the horizon, including reduced mark to market valuations for some real estate asset classes and a sustained period of elevated interest rates, delinquencies and defaults are likely to continue to rise. As these defaults mature into events of default, lenders will look to exercise remedies. Remedies typically include suing on the promissory note and/or any applicable guaranties and foreclosing on the underlying security instrument. In most states, lenders may pursue one or more remedies simultaneously. In New York, however, the "one action rule" prevents lenders from pursuing multiple actions simultaneously.

Set forth in Section 1301 of the New York Real Property Actions and Proceedings Law (NYRPAPL Article 13), the one action rule provides that, "While [an] action is pending or after final judgment for the plaintiff therein, no other action shall be commenced or maintained to recover any part of the mortgage debt, including an action to foreclose the mortgage, without leave of the court in which the former action was brought"**[2]**. Practically speaking, this rule limits lenders' debt recovery options to either foreclosing on the mortgage or suing on the note and any applicable guaranty, but not both.

There are three exceptions to the one action rule. First, as provided in the statute, simultaneous actions are permitted where authorized by the court. Second, simultaneous actions are permitted where the same property secures separate debts or where recourse is triggered under a guaranty after a foreclosure action has commenced**[3]**. Lastly, despite loan documents providing for New York law to govern said documents, courts have held that the one action rule does not apply to properties located outside of New York**[4]**; however, it is not certain that all courts outside of New York will similarly hold that the rule does not apply.

Because the one action rule prevents simultaneous actions, lenders must carefully consider which path will be most efficient to maximize their recovery. As discussed below, each path has its own set of limitations.

A lender's first instinct might be to accelerate the debt and sue on the note. It's relatively efficient and will result in a money judgment in favor of the lender. But lenders should be mindful of the fact that borrowers are often special purpose entities with limited assets, *i.e.*, the property and the cash flow thereof. So, it is likely that they will not have sufficient funds to satisfy the judgment. In addition, since most commercial mortgages are non-recourse, lenders are limited to recourse to the property in satisfaction of the debt as their sole remedy absent "bad acts" by the borrower or its affiliates. The one action rule provides that, "Where [a] final judgment for the [lender] has been rendered in an action to recover any part of the mortgage debt, an action shall not be commenced or maintained to foreclose the mortgage, unless an execution against the property of the [borrower]...has been returned wholly or partly unsatisfied"**[5]**. Requiring the lender to exhaust collection efforts before commencing a foreclosure action is time consuming, which in turn may cause the lender to suffer opportunity costs associated with not being able to redeploy the capital elsewhere. Considering the timing concerns and limited recourse opportunities for the lender, lenders should be certain that there is an upside to pursuing an action on the note before foreclosing on the property.

Likewise, a lender may also sue on an applicable guaranty. Here, just as with the note, lenders would still be required to exhaust collection efforts on any resulting judgments before they can foreclose on the property. For guaranties, it is important to understand exactly what obligations are guaranteed and whether any resulting liability is capped at an agreed amount. Most non-recourse guaranties provide for both full recourse and loss carveouts. Full recourse is typically triggered by certain "bad boy" acts like voluntary or collusive involuntary bankruptcy and impermissible debt or transfers, while loss carveouts have a wide array of triggers like losses from environmental or zoning issues. The most important distinction is that a full recourse breach makes the guarantor liable for the entire amount outstanding under the loan, while a loss carveout limits the lender's recovery to the amount the lender can prove it suffered as a loss as a direct result of the trigger event. In addition to understanding what is covered by the guaranty, it is also important for lenders to analyze the economic viability of the guarantor. Is the guarantor viable on the eve of foreclosure – and will they still be viable after a protracted foreclosure battle? Before electing to sue on any guaranties, lenders and their counsel should critically analyze both the economic viability of the guarantor and the recourse opportunities provided by the guaranties.

The last option lenders have at their disposal is to foreclose on the property with the recovery being equal to the proceeds from the foreclosure auction. This option is likely the first choice barring extenuating circumstances, so the lender is looking to the property to recover a large portion of the outstanding debt. As one might expect, the foreclosure process is not an exhaustive remedy. Foreclosure auctions often yield less than the amount outstanding, so lenders will need to seek a deficiency judgment within 90 days of the confirmation of the foreclosure sale**[6]**. Otherwise, the proceeds of the sale will be deemed to have fully satisfied the obligation. It is also important that lenders name – in addition to the borrower – any guarantors in the initial foreclosure action in order to preserve the lenders' ability to collect on a resulting deficiency judgment should that recourse be available**[7]**. It is also worth noting that in New York, foreclosure is not particularly efficient. Lenders can expect the foreclosure process to take at least 12 months, and during that time, lenders are barred from simultaneously pursuing an action on the note or guaranty.

The one action rule unearths a new appreciation of the popular legal phrase "one bite at the apple." Typically reserved for the estoppel doctrine, it fits nicely as a metaphor for lenders exercising remedies. It takes more than one bite to finish an apple. Likewise, it typically takes more than one action for a lender to fully recover an outstanding debt. Regardless, the one action rule presents numerous opportunities for lenders to foot-fault during their collection efforts. Because each case is unique, lenders must diligently evaluate the circumstances for each loan and fully appreciate the consequences presented by each possible path.

[1] Trepp, "**CMBS Delinquency Rate Shoots Up in May 2023 – Biggest Jump Since June 2020: Overall Rate Hits 14-Month High**."

[2] N.Y. Real Prop. Acts. Law § 1301(3).

[3] *See* 172 Madison LLC v. NMP-Group LLX, et al., 977 N.Y.S.2d 688 (N.Y. Sup. 2013).

[4] *See* Wells Fargo Bank Minnesota, N.A. v. Cohn, 771 N.Y.S.2d 649 (1st Dept. 2004).

[5] N.Y. Real Prop. Acts. Law § 1301(1).

[6] N.Y. Real Prop. Acts. Law § 1371.

[7] *See* Cent. Mortg. Co. v. Davis, 53 N.Y.S.3d 325 (App. Div. 2017).

Banking Agencies Finalize Interagency Policy Statement on CRE Loan Workouts

July 31, 2023

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On June 30, the Federal Reserve Board ("**FRB**"), Federal Deposit Insurance Corporation ("**FDIC**"), Office of the Comptroller of the Currency ("**OCC**") and the National Credit Union Administration ("NCUA") finalized their **Policy Statement on Commercial Real Estate Loan Accommodations and Workouts** (the "Policy Statement"). The Policy Statement will be effective upon publication in the *Federal Register*.

The Policy Statement is substantially similar to what the agencies **proposed last year** and supersedes the previous commercial real estate ("CRE") loan workouts from 2009. The Policy Statement "reinforce[s] the message that financial institutions should work prudently and constructively with creditworthy commercial borrowers experiencing financial difficulties, and clarify that such message applies in all stages of the economic cycle…[and] ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers."

This year's Policy Statement includes additional discussion of two topics. First, the Policy Statement included updated discussion in light of the implementation of accounting changes under the Current Expected Credit Loss ("CECL"). The CECL accounting rules phase out the previous treatment of Troubled Debt Restructurings ("TDRs"), and the final Policy Statement reflects those changes. Second, the final Policy Statement added additional guidance on short-term accommodations informed by the experience during the COVID event.

Although the Policy Statement has been in the works for a year, the timing may prove to be prescient as there are some who expect CRE loans to experience some stresses as demand for CRE may have changed after the large-scale working from home or hybrid shift in the workplace.

*(This article originally appeared in Cadwalader's **Cabinet News and Views**, a weekly newsletter on the financial services industry.)*

How to Prepare for a Real Estate Enforcement in Europe, Part 4 – Challenges

July 31, 2023

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In this mini-series on European real estate enforcements and restructurings, we have covered how to prepare for an enforcement in Part 1, emphasised the importance of valuation evidence in Part 2 and highlighted key enforcement implementation considerations in Part 3. In this final installment, we will cover how lenders can best position themselves to face challenges from stakeholders looking to stop an enforcement process.

Challenges by Stakeholders

It is impossible to predict with exact certainty the types of challenges that stakeholders may launch against a creditor leading an enforcement process. That said, lenders may be faced with the following:

1. Uncooperative Directors

Firstly, directors or shareholders of the debtor company may actively resist the enforcement. A common strategy used by opposing stakeholders is to directly attack the conduct of the lenders through an onslaught of correspondence. This strategy could be enough to "muddy the waters" and complicate a lenders' enforcement strategy, or cause the lenders to become nervous and reluctant to undertake their planned enforcement action.

2. Applications to Court

There is a risk (however remote) that a stakeholder could apply to Court on an urgent, expedited basis seeking to stop the enforcement. For example, the company may seek an injunction to stop a lender exercising its power of sale in relation to the secured property or a declaration that the lender's actions are not permitted (such as raising technical challenges on the enforcement documentation).

Theoretically, there is a risk that disgruntled stakeholders (such as directors, shareholders or junior creditors) could even apply to Court without first giving notice to the senior lenders of their application. In this situation, the applicants would need to establish that there was an exceptional urgency, and an imminent risk that the real estate asset would be materially impacted by the enforcement strategy proposed by the lenders. It is, however, an onerous task to show urgency, and the directors would need to successfully justify why they did not inform the lenders of their Court application. For these reasons, the risk of challenging directors taking this unilateral action without notification to the lenders is remote.

Risk Mitigation and Defensive Steps for Lenders

So, in a situation where a lender is faced with a board of directors who are being difficult and opposing their proposed enforcement plan, what defensive steps can a lender take?

- Firstly, as emphasised throughout this mini-series – *and particularly in **Part 2*** – valuation evidence is **critical**. Robust valuation evidence should always be obtained. In enforcement situations where there is a risk of challenge, this becomes even more important. Robust valuation evidence can be an effective "shield" against litigation risk.
- As part of good practice lenders should ensure accurate files are kept. In particular, detailed, contemporaneous file notes of discussions with the borrower can be an important record for lenders when defending their actions.

- Next, a robust letter to the board reminding the directors of their legal duties can be a sensible step. The letter should stress the duties of a director of a financially distressed company, and, in particular, the duty of directors to consider the interests of creditors. If the lenders are concerned that the opposing directors may make an application to the Court, this letter may also act as an opportunity to put the company on notice that if any such application were to be made, the directors will be liable for any adverse costs incurred by the lenders in defending the action.
- A more fulsome option for the lenders when dealing with difficult management would be to exercise their voting rights under the security documents. Typically, an English law share pledge will provide that following an event of default a lender can exercise the member’s voting rights in the company which would allow the lenders to change the board. Lenders could seek to replace the directors and appoint their own preferred (suitably qualified) company directors in order to manage the company with the interests of creditors in mind. It is worth considering the fact that the replacement directors must be willing to immediately accept the appointment, which may come with a degree of challenge, particularly if the company operates in a highly specialised or regulated area of business.
- Alternatively, the lenders could seek to appoint administrators over the holding company. The administrator would then be granted the power to change the board (removing the opposing directors). However, any move to appoint administrators should be carefully considered and taken in line with legal and financial advice.

Enforcement Checklist

In summary of our four-part mini-series, the below checklist sets out the key considerations for lenders actioning a real estate enforcement.

1. Structure	What is the structure of the company? It is critical to get the structure right when the deal is negotiated, as this can aid enforcement later down the line. Understanding weaknesses in structure and security provisions is essential.
2. Events of Default	What Event of Default has occurred? It will always be preferable to enforce on the basis of a clear, objective Event of Default.
3. Waivers and Amendments	Use these requests as an opportunity to tighten permissions, obtain more information, and to engage advisers to aid in the enforcement preparation stages. Preparation is key!
4. Security	Have you engaged lawyers to conduct a security review? Knowing how security can be enforced and how long an enforcement might take is crucial. Enforcement procedures may differ considerably across Europe, particularly as not all jurisdictions on the Continent are as “creditor-friendly” as the UK (and local law advice should always be obtained).
5. Valuation	Expert valuation evidence is key! Have you engaged an independent expert with experience in valuing the specific type of target real estate asset? This will be important for secured creditors to assess if the sale proceeds can repay their debt.
6. Stakeholders	Are you the only creditor? If more than one creditor is involved, it is essential to quickly understand their strategy and start working on an agreement as to how the enforcement should be implemented. Do you need management support to execute the real estate enforcement? Think about the practical aspects of the implementation and whether there is a chance that the company directors could oppose the proposed strategy.
7. Selling the Asset	How will the real estate asset actually be sold? This is a secured creditors’ key remedy. It is crucial to understand what the enforcement strategy will look like, how much it will cost, timings, any additional regulatory or statutory hurdles, and whether or not management input will be needed.

National Security and Investment Act 2021, Part 4 – Impact on the Real Estate Finance Market

July 31, 2023

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In this month's edition of *REF News and Views* we are going to wrap up our series on the National Security and Investment Act 2021 (the "NSI Act") and explore the NSI Act's impact on the real estate finance ("REF") market.

In last month's edition of *REF News and Views* we **explored** the sanctions available under the NSI Act for non-compliance. We explained that the Secretary of State for Business, Energy and Industrial Strategy (the "Secretary of State") has wide-ranging powers to "call-in" transactions if:

- it reasonably suspects that a trigger event has taken place in relation to a certain type of entity (a "qualifying entity") or asset ("qualifying asset") in the UK in one of the designated 17 sensitive sectors (the "sensitive sectors"); or
- there are arrangements in contemplation which, if affirmed, will result in a trigger event taking place in relation to a qualifying entity or qualifying asset.

Further, we highlighted that the NSI Act regime is far-reaching with serious consequences for non-compliance. The Secretary of State has the power to impose remedies to address any national security concerns or risks, including:

- a transaction requiring mandatory notification to be void if completed without approval;
- the imposition of civil fines of up to the higher of £10 million or 5% of worldwide turnover for non-compliance, including competing a notifiable transaction without approval. This can include a "daily rate" fine (of up to £200,000 or 0.1% of turnover per day) to incentivise rapid compliance;
- civil enforcement including injunctions to enforce compliance; and
- criminal sanctions for non-compliance (including completion of a notifiable transaction without approval, non-compliance with an order, or non-compliance with a requirement to provide information), with penalties including fines, imprisonment and disqualification as a director.

Impact on the REF Market

How does the NSI Act impact on the REF market? At a holistic level, lenders should carefully consider the implications of the NSI Act in respect of their secured lending transactions, especially when it comes to the taking of share security and prior to taking any enforcement action.

When managing a transaction, counsel should factor in possible delays while waiting for ISU approval on the deal timeline and transaction execution. As inconvenient as any potential delays may be, the severity of the consequences of failure to obtain prior approval far outweighs this.

Consideration in Respect of the Type of Assets

While lending and taking security are not in of itself within the mandatory notification regime, the nature of the underlying transaction which is being financed needs to be carefully considered when assessing whether a mandatory or voluntary notification should be made.

Assets may be subject to the regime where they are closely linked to the activities of the sensitive sectors or in other areas that are closely linked to those sectors. Land may also be an asset of national security interest where it is, or is proximate to, a sensitive site (such as critical national infrastructure sites or government buildings) or because of the intended use of the land. This is perhaps the most important issue to consider in REF deals.

As we have previously noted, if there is a trigger event in relation to a property holding SPV that is a qualifying entity and that SPV carries on a particular activity in one of sensitive sectors in the UK, then this will fall within the mandatory regime and require notification.

Equitable Charges over Shares

One of the most relevant questions to the REF market regarding the NSI Act is whether the creation of equitable charges under secured lending transactions could constitute a trigger event under section 8(2) of the NSI Act such that a charge could be within scope of the mandatory notification requirements, because to do so would have far-reaching consequences.

Following discussions between Department for Business, Energy and Industrial Strategy ("BEIS") and the City of London Law Society ("CLLS"), BEIS offered the following **guidance**:

> "Whilst the grant of a security over shares could create an equitable interest in such shares, such an interest would not appear to grant any control over such shares, as referred to in section 8(1) [of the NSI Act], until the happening of an event that would provide control. Therefore we do not think this falls within the scope of mandatory notification until such an event that would grant control.
>
> Notwithstanding the above, the Government is considering whether any further clarification is appropriate and, if so, what format that should take."

Accordingly, on the basis that any equitable share charge would not appear to grant any control over such shares unless an event providing control occurs, a secured lender would not need to notify or obtain pre-clearance from the Secretary of State at the point of creation/grant of such share charge, even if the shares relate to a qualifying entity. We would expect that the majority of share changes in REF deals are structured on this basis.

However, it should be noted that any enforcement action could be also be a triggering event requiring BEIS approval. This is worth considering as it may affect the timing of the enforcement of the security as a lender may need to seek approval from the BEIS in order to transfer or sell the shares in question.

In this regard, we would strongly suggest that lenders seek specialist advice at the point of taking security and prior to any enforcement action.

Closing Thoughts

We would like to conclude our NSI Act series by pointing out that the NSI Act presents a narrow but deep risk. Lenders and investors should give due consideration to the NSI Act in order to protect their transactions and officers from potential criminal liability and other significant punitive measures. They should also ensure that they are cognisant of the new rules given the broad scope of the mandatory notification system under the NSI Act.

Recent Transactions

July 31, 2023

Here is a rundown of some of Cadwalader's recent work on behalf of clients.

- Represented the administrative agent and lender in a $275 million mortgage loan to finance a data center in Garland, Texas that is leased to a leading U.S. technology company.
- Represented the lender in a $100 million aggregation credit facility for a real estate investment firm to finance the acquisition of various self-storage properties.
- Represented the lender on an acquisition loan with respect to a beachfront resort hotel in Hawaii with a $30 million future funding component for planned renovation work at the hotel.
- Represented the lender on a series of conduit loans secured by single-tenant properties throughout the U.S.
- Represented the purchaser of a $51,862,500 mortgage loan providing for future advances for renovations to a multifamily property located in Antioch, Tennessee from originating lender and holder of related mezzanine loan.