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Governmental Considerations Attendant to a Mezzanine Loan Foreclosure

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By **Emanuel Tsourounis II**
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The foreclosure of a mezzanine loan (or the acceptance of a transfer of the pledged equity interests in lieu of foreclosure) and its timing are decisions that require careful consideration and planning.

Unlike a mortgage foreclosure, title to the property will not be conveyed to a new owner free and clear of subordinate liens and encumbrances and other obligations or liabilities of the existing property owner. Instead, a foreclosing mezzanine lender (which, for purposes of this article, will also include any purchaser of the pledged equity interests at foreclosure or a designee of the mezzanine lender that acquires the pledged equity interests by transfer in lieu of foreclosure) will "step into the shoes" of that property owner and, in so doing, acquire only an indirect interest in the property, subject to all claims, liabilities, agreements or other obligations to which the property owner or the property is subject or otherwise bound.

A foreclosing mezzanine lender must properly obtain the benefits expected from acquiring the pledged equity interests in the property owner within the parameters prescribed by the intercreditor agreement, which governs the relative rights, priorities and obligations of the mezzanine lender and any other lenders (whether senior or subordinate to the mezzanine lender) that have provided financing for the property, and applicable law. While this article is limited to a discussion of governmental franchises, licenses, permits, approvals, authorizations and the like, there are a myriad of other issues attendant to a mezzanine loan foreclosure, such as compliance with loan documents, intercreditor provisions and UCC requirements.

Upon a change in ownership of the property owner, the foreclosing mezzanine lender will need to update the registered agent, registered office and/or mailing address of the reconstituted property owner with the secretary of state (or other applicable government official) of the state in which the property owner is organized, as well as any other state in which the property owner is qualified to do business, to ensure that annual or biennial statements and/or invoices for franchise taxes are mailed to its correct address and service of process upon the property owner in any action, suit or other proceeding in such state is made upon the appropriate agent. If these updates are not timely made, the property owner may be at risk of losing its good standing or having its status as a legal entity revoked or cancelled in the state of its organization and, if applicable, any other state in which it is qualified to do business. The property owner may also be at risk of an adverse outcome, including a determination of liability and/or damages, in any action, suit or proceeding involving the property owner for failure to serve an answer to, or appear in, such action, suit or proceeding.

While virtually all licenses and permits will require the foreclosing mezzanine lender to update the issuing entity of the new mailing address of the reconstituted property owner, a subset may also entail compliance with additional requirements in order to continue the validity of those licenses and permits, or to prevent their revocation or suspension, as a result of the change in ownership of the property owner. For example, liquor and gaming licenses for hospitality properties and operational licenses for health care, assisted living and skilled nursing facilities are generally subject to additional requirements, ranging from filings describing the change in ownership of the property owner to background checks for its new officers, directors and/or principals or even a requirement for making application for a new license or permit following the change in ownership. By contrast, if a license or permit was issued to a third-party operator or manager which will survive, or constitutes an entitlement of the property that will remain in effect, then no further action may be required. When an existing license or permit is rendered invalid or is revoked or suspended, or a new license is not issued, the reconstituted property owner may be required to suspend or cease the affected business or operations at the property until the license or permit is reinstated or a new license or permit is issued.

Special consideration should be given to condominium development projects, which are especially challenging to a foreclosing mezzanine lender for a number of reasons. These projects may involve completion of project construction and the marketing and sale of units (unless the mezzanine lender opts to abandon the condominium plan and convert the project to a rental property). The same defaults that would lead a mezzanine lender to decide to foreclose, and the foreclosure itself, often result in delays in construction and additional costs, which must be disclosed (along with the change in ownership of the property owner) to existing and prospective unit purchasers and which may necessitate additional filings with the relevant state office or officials and amendments to the condominium documents and/or plan. The preparation, filing and approval of these required disclosures and amendments can be costly and time-intensive, and the disclosures may trigger rescission rights of unit purchasers under the terms of existing contracts and/or applicable law. In addition, these factors may have a chilling effect on future marketing efforts and unit sales (as well as the sales prices for such units), which, in turn, may impact the timing of the effectiveness of the condominium plan or the financeability of unit purchases, or both.

Because so much of the value of the collateral for a mezzanine loan depends upon the continued existence of the property owner and the maintenance of governmental franchises, licenses, permits, approvals and other authorizations to develop, use, operate and sell the property, the importance of giving due consideration to these matters when contemplating whether and, if so, when, to conduct a mezzanine loan foreclosure cannot be overstated. The mezzanine lender must carefully consider the scope of these franchises, licenses, permits, approvals and authorizations and understand the applicable laws, rules and regulations pertaining to their maintenance and continued validity following a change in ownership of the property owner.

Property Insurance in Real Estate Finance Transactions

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By **Duncan Hubbard**
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This article examines the practical considerations that a Lender should consider in regards to insurance of the underlying collateral, as well as the legal benefits of co-insurance and properly packaged security.

Modern real estate finance transactions will often deal with a myriad of vehicles within a structure, each holding real estate in certain jurisdictions, acting as either a primary borrower or an obligor pledging security to enable a group refinancing.

For the purposes of this article we will generalise the property holder/insured party as the "Borrower" and will refer to the lending secured party (such as the security trustee for noteholders, structurally subordinated creditors or senior banks) as the "Lender."

Please note that this article does not touch upon Warranty and Indemnities insurance and other products which are typically taken for the benefit of the buyer/borrower (which can be charged to a Lender).

The typical packages available

Assigning the proceeds of the policy to the Lender

The charging document will assign to the Lender the Borrowers' rights to receive the proceeds of an insurance claim, providing the Lender with direct recourse to the insurance policy (and the right to even sue the Insurer directly). These monies will often be required to be paid into secured bank accounts operated by the Lender and, provided the loan is in compliance, will typically be released by the Lender back to the Borrower in order that the Borrower may utilise proceeds for their purpose. Notice of the assignment will need to be given to the Insurer to ensure the assignment is immediately legally effective (assignees rank in the order in which notice of their assignment has been given to the Insurer). Charging the policy proceeds without having the benefit of composite insurance means that there is always the possibility that any action taken by the Lender to enforce the Insurers to pay out could theoretically be met by a claim from the Insurers that the Borrower already breached the insurance contract and rendered it void.

Endorsing or 'noting' the Lender's interest on the policy

Essentially, this provides some but otherwise limited practical benefit. This can provide a prompt on the face of the contract that might deal with a material issue – for instance, the Insurers being able to notify the Lenders of a failure to pay the premium. There is, however, no contract between the Lender and the Insurer here, so if the Insurer fails to notify the Lender, it is doubtful that successful legal action could be taken by the Lender if loss is suffered.

Designating the Lender as first loss payee of any payment made under the policy

Essentially, the Borrower is designating that the proceeds (typically above a certain threshold) be paid directly to the Lenders. As with endorsement, it is a statement written upon a contract that the Lender is ultimately not a party to and, as such, enforcing any rights by the Lender is not going to be straightforward.

Composite Lender insurance

This involves making the Lender a composite insured party under the policy so that it has independently enforceable rights which are not weakened by any failure by the Borrower to comply with the policy.

Important considerations

In negotiating and agreeing to the Lenders' requirements with the Borrower, various considerations need to be given at an early stage, especially where there are multiple secured properties:

- The practicalities, viabilities and legal realities must be explored as a primary matter. What can sensibly be achieved within the timelines available for the financing, and what is workable in terms of prudency and regulation? Many large property companies hold block insurance policies for the benefit of its group companies. Whilst some policies will allow Lenders' rights to be "noted on the policy," it is, of course, unlikely that the Lenders will be able to obtain an assignment of overall proceeds unless the insurance is specifically drawn and segregated into separate properties for individual claims. For the same reason, designating a Lender as first loss payee may be unworkable.

- Does the Borrower actually have a direct contractual claim with the Insurers? This may seem an odd question; however, in some parts of Europe, it is the retained obligation of the ultimate land owner (as opposed to the tenant in possession) to insure the property. Whilst the tenant may have contractual recourse through its lease against its Landlord for failure to insure, is this indirect claim sufficient for the Lender? Is the Lender essentially taking a credit assessment/risk on the performance of its Borrowers' Landlord?
- The Lenders' internal regulations. Is composite insurance going to be required and, if so, who will pay the premium?
- The Insurers themselves. Are they prepared to negotiate the standard terms or does the Borrower need to consider another Insurer?
- Governing law. It is frequently the case that a policy over property in one jurisdiction is governed under a different jurisdiction. However, where a block policy will insure properties in a number of jurisdictions, the policy cannot be subject to multiple governing laws at once. An early assessment is therefore vital to ensure that the Lenders obtain the correct securities.
- Regulation and legal guidelines. Lenders across Europe rely on industry guidelines, such as the VDP German association of Pfandebriefe Banks and the British Banking Association. Industry guidelines often dictate best practices in some jurisdictions which may be different from others, and legal/regulatory frameworks sometimes require specific matters to be complied with. Failure to address these issues could cause an issue during syndication.

The risks of 'derivative' protection

Each of the first three routes outlined above ("Assigning the proceeds of the policy to the Lender," "Endorsing or 'noting' the Lender's interest on the policy," and "Designating the lender as first lost payee of any payment made under the policy") are essentially "derivative"; they are derived out of the Borrowers' rights under the terms of the insurance with the Insurer, and, as such, the level of protection comes with risks, in particular, that the Insurer could raise defences due to non-compliance by the Borrower which affect the pay out, or indeed validity of, the insurance. The risk of issues presenting themselves is further exacerbated by the fact that the Lenders will have no direct contractual recourse to the Insurers in any event.

Whilst, for instance, properly drawn loan documentation would place prohibitions on the Borrower amending the terms of the policy, the Lenders will not have any recourse against the Insurers if the policy was changed without the Lender's knowledge. Arguments could certainly be put together to assist a Lender in certain situations – for instance, where the proceeds of the policy were assigned to the Lender ("Assigning the proceeds of the policy to the Lender") and the Insurer fails to pay out to the Lender, then it is theoretically possible in some European jurisdictions to take actions claiming third-party rights under contracts. Claims can be thwarted, though, from clauses in the contract that seek to restrict third-party rights; furthermore, practically speaking, the Insurers may also have the defence that when the Borrower breached its contract, the policy had as a result lapsed or become void.

Ultimately, with the "Composite Lender insurance" route outlined above, a Lender can seek to be made a composite insured party under the policy to give it the maximum protection available. This would provide the Lender with the ability to make its own separate claim independent of the Borrower's position alongside the Lender. Providing the policy is properly negotiated, the Lender will be protected even against breaches of the policy made by the Borrower, such as claims by the Insurer that the Borrower has vitiated the policy through non-compliance or by failing in its duty of disclosure and upmost good faith to the Insurer. The policy will need to contain a provision to the effect that the insurance shall not be invalidated against the Lender for non-payment of premium without the Insurer giving the Lender written notice. The policy should also contain a standard mortgagee protection clause, waiver of subrogation against Lender or no disclosure obligations on the Lender.

Finally, it is worth reminding that whilst protective measures and compliance requirements will appear as standard in well-drafted European Senior Lending documentation (such as those found in Loan Market Association documentation), which typically require confirmations that composite insurance is in place with various other Lender-protective measures for the benefit of the Lender, these confirmations should be checked through due diligence and, at the least, a letter from the insurance broker to confirm that the policy meets the requirements set out in the lending documentation.

Exposure and Remedies under Completion Guaranties

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By **Michael S. Anglin**
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Under a completion guaranty, sometimes referred to as a "cost overrun guaranty," the guarantor typically guarantees any excess of the cost of completing construction over the portion of the construction loan allocated to funding construction costs.

The lender will usually have all or some of the following three remedies: (i) requiring the guarantor to complete construction, in which case the guarantor will be entitled to draw undisbursed amounts of the construction loan allocated to construction costs, as these costs are incurred; (ii) the lender itself completing the construction, with the guarantor being obligated to reimburse the lender for costs incurred to the extent they exceed the undisbursed loan amount allocated to construction; and (iii) most importantly, collecting from the guarantor a payment in an amount equal to the estimated cost of completion less any undisbursed loan proceeds allocated to construction, which is referred to as a "liquidated damages" remedy. The guaranty will usually provide that the cost estimate is to be made by the lender's construction consultant, sometimes with the lender having the right to approve or override the consultant's estimate. The construction consultant and/or the lender will typically be required to make the estimate in good faith, sometimes with a reasonableness standard, and, although not typical, under some completion guaranties the guarantor will have the right to have the liquidated damages determined by arbitration.

The liquidated damages remedy is important to the lender for several reasons. This remedy gives the lender maximum flexibility in that it allows the lender to terminate the guarantor's involvement in the project, as opposed to requiring the guarantor to complete construction, and does not require the lender to itself perform any construction, as would the remedy of being reimbursed by the guarantor for cost overruns. The liquidated damages remedy allows the lender to monetize the guarantor's obligation and collect it irrespective of whether the lender completes construction. In addition, since the liquidated damages can be rapidly determined (assuming no arbitration provision), it affords the lender additional leverage in negotiating a settlement or workout. The party liable under the completion guaranty will often also be the guarantor under a carry guaranty, under which the guarantor guarantees to the lender the payment of interest, taxes, insurance and other carry costs. A carry guaranty may allow the guarantor to terminate the guaranty and cut off its continuing liability thereunder by tendering to the lender a deed-in-lieu of foreclosure upon satisfying specified tender conditions. These conditions will often include that the guarantor has satisfied its obligations that are then due and owing under all other guaranties relating to the loan. Because liquidated damages can be quickly determined and demanded, this remedy under a completion guaranty affords the lender the ability to exert pressure on the guarantor by requiring that it pay the liquidated damages in order to satisfy the tender conditions under the carry guaranty and terminate its ongoing liability for carry costs.

The guarantor, in negotiating a completion guaranty, will want to make sure that it is guarantying nothing more than construction cost overruns, and that it is given full credit for undisbursed construction proceeds, as well as any reserves held by the lender that are intended to cover construction costs, including reserves funded due to balancing calls. Loan documents typically give the lender the right during the continuance of an event of default to apply reserves against any obligations under the loan documents, as determined by the lender in its sole discretion. Although usually overlooked by the guarantor, the guarantor should want the completion guaranty to provide that it will be given credit for any funded balancing calls covering construction costs and other construction reserve amounts that the lender applies to obligations other than the guarantied construction costs. If the lender requires the guarantor to complete construction, the guarantor will want to exclude from the conditions that it is required to satisfy in order to draw construction proceeds any conditions that it is incapable of satisfying (*e.g.*, the failure of the borrower to comply with special purpose entity requirements), as well as any conditions that would require it to expend funds beyond the amounts that it is otherwise liable for under the completion guaranty. The most favorable outcome for the guarantor is to limit its draw conditions to those that directly relate to the construction (*e.g.*, adequate performance of the work, delivery of architect's or contractor's certifications and delivery of lien waivers).

In the event that the lender chooses to complete the construction and seek reimbursement from the guarantor, the guarantor will want to limit the lender's ability to do things that can potentially increase costs, such as modifying plans and specifications and replacing construction and design contracts. The lender, however, will want at least some flexibility to modify plans and specifications and to replace contractors when it believes it is necessary to do so. Finally, bad act guaranties sometimes cover losses arising out of mechanics' liens. The guarantor will want to exclude mechanics' liens arising out of the construction work guaranteed under a completion guaranty because, unlike a completion guaranty, under a bad act guaranty the guarantor is not entitled to credit for undisbursed construction proceeds.

As the above is intended to demonstrate, completion guaranties require careful attention at the negotiation phase, including coordination with other guaranties, from the guarantor's perspective, to ensure that the guarantor is not taking on exposure beyond construction cost overruns, and from the lender's perspective, to ensure that the lender has adequate remedies should it become necessary to invoke the guaranty.

Recent Matters

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

- Represented the agent, on behalf of a bank group, with respect to a $145,075,000 loan secured by a mixed use property located on the Upper East Side of Manhattan.
- Represented the administrative agent, mortgage lender and mezzanine lenders on a $560 million loan with two layers of mezzanine debt to finance the acquisition of Chase Tower in Houston, Texas.
- Represented the agent, on behalf of a bank group, with respect to a $64,600,000 loan secured by an office building located in Boston.
- Represented the lender in four separate, uncrossed mortgage loans to a subsidiary of Blackstone, each secured by a multifamily property in Las Vegas, Nevada.