Business Better (Season 4, Episode 1): Distressed Office Buildings: A Look at Workout and Enforcement

Speakers: Dominic De Simone, Brian Schulman, Raymond Qualia, William Wassweiler, and Karla Vehrs

Steve Burkhart:
Welcome to Business Better, a podcast designed to help businesses navigate the new normal. I'm your host, Steve Burkhart. After a long career at global consumer products company BIC – where I served as Vice President of Administration, General Counsel, and Secretary – I'm now Special Counsel in the Litigation Department at Ballard Spahr, a law firm with clients across industries and throughout the country.

Realigning an underperforming property and its attendant financing takes a high degree of detailed knowledge not only of the particular building, but the market and industry as a whole. In this episode, five members of our national Distressed Office Buildings team share their perspectives on the key considerations office building owners and their lenders should focus on as they take stock of their particular situation.

Leading this discussion is my Ballard Spahr colleague Dominic De Simone, who co-chairs our national Finance Department. He is joined by Brian Schulman, Raymond Quaglia, William Wassweiler, and Karla Vehrs, whom together have decades of cumulative experience in real estate workouts and enforcement. So now let's turn the conversation over to Dom.

Dominic De Simone :

I'm Dominic De Simone. I'm the co-chair of Ballard Spahr's National Finance Department. I'm pleased to be moderating our program today. Today's program will focus on workout and enforcement considerations from a lender's perspective. I'm happy to be joined today by my partners, Brian Schulman, Ray quaglia, Bill Wassweiler, and Karla Vehrs. All them have extensive real estate workout and enforcement experience representing a range of parties across a variety of deals and projects. We're going to begin with each of them providing a short introduction and then we'll start our discussion.

Brian Schulman:

Hi everyone. My name's Brian Schulman. I'm a litigation partner in Ballard's, Phoenix office. I've been practicing for about 30 years, so I am a veteran of the great financial crisis and have been dealing with these issues for several decades now. So happy to impart whatever knowledge I can.

Raymond Quaglia:

I am Ray Quaglia. I am a litigation partner, co-resident in Ballard, Philadelphia and New York offices. I concentrate my practice on representing lenders special servicers in the distressed real estate, primarily CMBS area, and I am admitted and practice regularly in Pennsylvania, New York and New Jersey.

Bill Wassweiler:

Hi, my name's Bill Wassweiler. I am a partner in the Minneapolis office. Been practicing for over 25 years, always on the distress side and represent senior lenders, corporate trustees, whether it's a balance sheet type of default or high yield Muni or in the CMBS world all on the default side, bankruptcy, receiverships, you name it.

Karla Vehrs:

Hi everyone. My name is Karla Vehrs and I'm a partner in Ballard Spahr's Minneapolis office in our litigation department. And my practice also focuses on representing lenders special servicers and trustees in defaulted commercial real estate matters.

Dominic De Simone :

Great, thank you for those introductions. So we're going to start essentially down the road in the actual transaction at a point where it's now become clear that there is some type of problem. Maybe the loan is maturing and there won't be sufficient refinancing proceeds. Maybe the project is no longer cash flowing or is expected not to cash flow sufficient to support operating expenses and debt service. Maybe the project requires a capital infusion that the sponsorship is not willing to make for whatever reason, but it's at a point where now it's clear that there is a problem that is going to need to be significantly worked through with the borrower. So Karla, in that circumstance, take us through a little bit of that intake process and some of the considerations from the lender's perspective that happens when the asset moves over from its normal administration into an asset manager who's in the workout group or a special servicer.

Karla Vehrs:

Sure. Thanks Dom. So the first steps in the process, once the file comes over really involve making sure that you have everything you need in your paper file to start. So take a careful look, go back to the original loan documents and make sure that all of the steps along the way since the date of the loan documents have been well documented, right? Make sure you've got the assignments that you need, see if there are any personal guarantees in the file, what you've got there and see what has happened that might necessitate some cleanup at this stage of the game. Consider whether you need to get any waivers, whether there are consents or amendments that have been obtained or need to be obtained going forward. And considering where you're at in the moment, the file has now come into the special assets group or into special servicing.

So this is really a prudent point in time to make sure you're getting an updated title commitment, running some UCC searches, and then likewise getting a handle on the current market value for the property. So you'll find whatever appraisal was ordered at the time the loan was made, but depending on the deal, that may have been a number of years and obviously we're here because market circumstances have changed a lot. So an easy place to start is certainly with a broker and turning to a broker to get an opinion of value or alternatively going right for an appraisal to see what that opinion comes back at.

Bill Wassweiler:

And I think that's a really good point there, Karla. I mean when it comes to the values, I think that's key. And one thing we find problematic sometimes is actually getting an appraisal because a lot of times when you do that you need the cooperation of the borrower, which you may not get, but the BOVs is a great place to start as well.

Dominic De Simone :

Karla, in those situations too, as the file moves over and if folks are finding it may be incomplete in terms of operating information or even whether a pre-negotiations agreement for instance has already been executed, how do you advise lender clients where they have a situation that they need to begin proactively managing, but at the same time they'd be maybe lacking some basic information or basic documentation that you would normally expect for them to have or would recommend that they have?

Karla Vehrs:

Sure. Well, and that brings up two important points I think Dom and one is to look and see whether there is already a pre-negotiation agreement in place and if there isn't, certainly work on putting one together and getting that executed by the borrower. And I'm sure everyone knows what those are, but those are important agreements for just making sure you have a level playing field going into any negotiations with your borrower, getting everyone on the same page in signed written form, acknowledging among other things that there will be no modification unless the terms are reduced to assigned writing.

Making sure that there's no reliance on any sorts of discussions or representations along the way, things like that. I think it's also good at this juncture, to your point Dom, to make sure that you've got updated financial disclosures and any other borrower disclosures that you're entitled to under your loan documents. If you don't have them yet, there's no time like the present to go in and get them or given the circumstances that have changed to consider what other information you may want to get from the borrower as part of that pre-negotiations agreement or as a step just beyond that pre-negotiations agreement.

Brian Schulman:

Karla, I think it's also worth noting here that a lot of these loans have been subject to forbearance or modification agreements in the past. So I think that that would be a very important place to start because a lot of these documents that we're talking about now in a pull forward manner wouldn't have existed or should have existed as part of a forbearance agreement. And consistent with the discussion about the PNA, a lot of the terms that we're talking about putting in place in a PNA, which certainly would need to be updated to the extent we're talking about a new default situation that's unrelated to any prior forbearance or modification. A lot of the representations and warranties that you would see in a forbearance agreement would need to be pulled forward into a new PNA as well.

Karla Vehrs:

That's a great point.

Dominic De Simone :

I'm just curious for all of you in terms of certainly not the forbearance states, but sometimes it comes up at the pre-negotiations stage, some folks don't want to do anything until there's a modification. But in terms of expectations around releases, in terms of claims and so forth, what's your view on that? Obviously you want to move forward. Obviously there's a lot of benefit to the re-negotiation agreement separate and apart from releases that folks want to probably document as soon as they can, but how do you balance that element at an early stage in the process?

Brian Schulman:

Dom, I think that that depends largely upon what the imperative is by the lender. Sometimes it's very important for the lender to get the PNA in place and start the discussions going emergently. In which case the lender is going to be in a position where they're willing to forego some of the more lender friendly terms that you would typically find or typically want in a PNA like the releases. So if a borrower pushes back on the releases, if it's important for the lender to move forward from a business perspective, then sometimes you just decide to forego those provisions.

Also, a lot of the times we see pushback on the assurances that you typically would put into a PNA that the borrower will pay all costs associated with the modification. Sometimes we get pushback on that as well. That's an area where it would be nice to have it on the front end because, but it doesn't foreclose you from incorporating those terms in connection with any deal you ultimately do with the borrower. So even though you're giving it up at the PNA stage, it doesn't mean you're giving it up forever and you can put that into whatever modification agreement your consensual arrangement comes up down the line.

Dominic De Simone :

Okay, great. And would you say it's fair to say we've been talking about the PNA from a lender perspective, but certainly having the protection around open and free conversation and potentially really assessing the issues associated with the project borrower's ultimate ability to perform. There are benefits running in favor of the borrower too, to have all of those discussions essentially under the protection of the PNA so that they're not used against them later if they're basically saying that we can no longer perform from this point or we're running into issues here to avoid any type of alternative claims by the lender?

Raymond Quaglia:

I would agree with that. Although they're from the lender's perspective, we do them primarily for the protection of our clients. I think it's fair to say that the advantage to the borrower among others is they can engage in free and frank discussions with the lender's business people and try to work something out without having to go through counsel or have things be unnecessarily formalistic in their communications.

Dominic De Simone :

Great. So it sounds like it benefits everyone involved in getting the process moving forward. So Bill, I think Karla has started us off with a nice base in terms of that initial intake, but maybe you could talk a little bit more about some of the project and

market specific considerations in particular when you're dealing with an office building that you're really trying to assess and get your arms around.

Bill Wassweiler:

That sounds good. Yeah, my discussion's going to be more focused right now on the office space and some of the deals we've been working on recently because as everybody knows, there's been a quite a uptick in distressed office space. And we always start out. I always think of it as a decision tree in terms of how we move forward in a workout distressed office building. But the first thing, and some of this is pretty obvious, but know the parties, know the borrower. Is this the kind of borrower that you can work with? Is it the kind of borrower that's been withholding information, not disclosing financials, things like that. That's going to be key going forward to know your borrower, to know whether it's somebody you can work with. And the other parties, I mean the borrower a lot of times slash sponsor, especially on the larger class A building deals, but you're probably going to have a Mezz component and you got to consider the Mezz lender.

Obviously we're typically representing the senior lender, but is it just one senior lender or is it a syndicated deal? Are you the agent or not? All those things really factor into how this is going to move forward. And then I want to jump into what we mentioned before Karla did, appraisals or valuations. A lot of times it's going to be difficult to get an appraisal and obviously how credible are these in this type of a market, but what we typically do is at least get three BOVs on these deals. We need to figure out what we at least think that value is because that again will drive the next decision in terms of where are we going to go from here, structuring this through a forbearance agreement, likely is it going to be a consensual type sale, is it going to be a restructuring? You go down the tree and you think of, okay, is this something that we cannot market and sell other than at a significant loss?

Do we want to consider restructuring an AB note would be one thing or are we going to move into some kind of a consensual sale where we can get everybody on board through a forbearance agreement without talking about receiverships or anything like that. A lot of times these days I'm seeing lenders who are considering seller financing, stapled financing on these deals because of the valuations that are coming back. And so those are some big considerations as you move down and through that decision tree. Is it going to just be a marketed deal? Is it going to be seller finance deal? Is that how you're going to market or is everybody going to be in place?

One other thing I got to mention too that's key upfront is the management agreement. You get into some of these, especially the larger class A buildings, and there are some pretty ironclad management agreements out there and you got to look very closely at those. Are they market? Can you get out of them? They're very difficult to exit in some circumstances, and so you may be left working with that management company throughout the entire process. So that's another thing to consider, whether it's a receivership or a bankruptcy, even in a bankruptcy sometimes it's very hard to exit those agreements without significant penalties I would say.

Dominic De Simone :

Bill, that's a great overview. And just to pick up on that last theme that you mentioned about management, it seems like during this process you have an eye towards the longer term, like what is going to be the ultimate end game and you're gathering a lot of information and doing a lot of assessment. Meanwhile though, there's a project that needs to be managed, there's cash flow that needs to be collected, held, distributed out for operating expenses. Maybe there's leasing activity that is going on that the lender still wants to facilitate for the benefit of the building. How do you bifurcate that a little bit when you're talking with your clients, realizing that there's a short term, essentially an asset that you're trying to preserve and increase value and then a longer term analysis going on relating to the loan and its ultimate resolution.

Bill Wassweiler:

That gets into some of the terms of a forbearance or what you have in place already in terms of cash traps. I mean anytime you trigger a default, those are the things you want to take advantage of right away in terms of what, like I said, a cash trap for instance. What kind of control do you have, if any, over the leasing going forward? I mean that's always a big issue. And in a syndicated deal, is it going to just be the agent that's going to take care of that or under these scenarios, are you going to work at such that all of the senior lenders will have some say in the leasing going forward. But stabilizing that aspect of it, taking

control of the additional collateral, which is the cash is always significant, something you want to do right away and consider if you don't have it, definitely consider it in a forbearance agreement.

Brian Schulman:

So what impact does looking at the overall market environment have on the decision tree that you're making now? In other words you said know your borrower, know what's going on in the market. What do those inputs ultimately factor into when it comes time for a lender to make a decision on how to move forward?

Bill Wassweiler:

It's so significant and that's why I keep on going back to the BOVs for instance, because what is your exit strategy here, as Dom was talking about? Is this just going to be a restructuring because the values aren't there? Are you going to try and sell? Do you want it? Are you going to sell to a third party or is this something you want to bring back into ORE? So that all factors in right up front in terms of where you want go with this. Sell, keep an ORE, which if you're going to keep an ORE, you got to think about, okay, is this a syndicated deal? Can you get all the lenders on board to do it? So those are big concerns, things you need to think about before you develop your ultimate strategy going forward.

Karla Vehrs:

And I would maybe even simplify it a little bit further to say you really have to have your diligence in place to be able to make a judgment call not just one time, but all along the way as you go. As to is our problem here a market problem or is it a borrower owner problem? Meaning each of those scenarios has very different potential answers as far as how much time you give someone, how long you're willing to work under a forbearance agreement, when and whether and how you get a receivership put in place or whether you might move toward more the enforcement side.

Dominic De Simone :

I was going to say, I think that's an important point, and again, I know we're focusing from the lender's perspective. But from a borrower's perspective, maybe you can just reinforce the importance of a sense of transparency, honesty, the reality that a lot of lenders, I think can deal with, market challenges and issues and appreciate what owners are dealing with when there are factors beyond their control. And certainly in office, a lot of what has happened are factors beyond most owners control, whether it's the decrease in occupancy rental rates, increase in operating expenses, increase in interest rates, the challenges with loan refinancing and so forth. So I think there is an appreciation from the lenders in terms of all of those factors and often a willingness to sit down and really try to work together to figure out the best resolution.

Bill Wassweiler:

I got to say in a lot of these class A type buildings, as you probably read, a lot of it has to do with maturity defaults. So a lot of these have been just humming along fine, it is just we're at the maturity stage and so now what do you do because the valuations have dipped so significantly? So a lot of them on the larger deals are probably not as driven by actions by the borrower, but when you get into some of the class BC, you, I mean sometimes that's a consideration when you get into those types of buildings. Another one too is what are you going to do with it? Are you just going to sell as an office building or are you going to try and put part residential in there, which seems to be a big fad these days. I don't know how much that's really happening, but that is definitely a consideration too. Mixed use.

Dominic De Simone :

Yeah. Why don't we build out on that a little bit, Bill? I think that's an important point and certainly we've been hearing a lot about that in the marketplace and in the press. I think it's been more theory than in reality just because of a lot of the difficulties associated with conversion. They could be extremely expensive, they take a lot of time. The zoning might not be exactly what you need for the development to make the numbers work and so forth. From your perspectives, how are you seeing and hearing that and how would you advise someone when presented with a proposal that here's a possible solution

that could solve all of our problems, but maybe it requires a lot more time, money, other things that either a lender or the current ownership group don't seem to have at the time?

Brian Schulman:

Dom, it's the first silver bullet that they try to fire on this, right? And I think that if you're a lender receiving that sort of proposal, the amount of due diligence you need to do in order to evaluate it and it's got to be independent is enormous. But I think that that's the first easy answer for a borrower and an office project that's facing from distress, particularly B or C type product. But I think that a lot of the times folks end up listening to it, looking at it, recognizing pretty quickly that it's not the most feasible option out there and moving on, but it does require the lender to do their own independent evaluation.

Dominic De Simone :

Ray, I think you had a deal that had a version of that where it involved multiple office buildings under a single financing.

Raymond Quaglia:

We did. It was three significant office buildings, I think it was in Pittsburgh, and we basically had middling occupancy across three buildings and the borrower proposal was consolidate the tenants in two of the buildings and either repurpose the third building as multifamily housing or sell it for purposes of conversion to a third party. Obviously in the CMBS world, plans like that also raise REMIC issues. I'm not a REMIC lawyer, a tax lawyer, but that's something else that the lender needs to look at, an added wrinkle in the CMBS side.

Dominic De Simone :

Yeah, I think we'll probably see more of those as this plays through with office campuses involved with five properties, buildings that you bring them down to three and try to do something with the other two or the excess land. We've spoken to a lot of clients who are actually on the buy side of some of those situations looking for the potential to essentially either redevelop the buildings or take advantage of excess land that can then be redeveloped as well. And Karla, I think you have made the point that at least some folks in the industry are saying that in some circumstances thinking about the building as is and being there may not really be the right analysis.

Karla Vehrs:

Yeah, that's exactly right, Dom. The reality is when it comes to conversions, even though it's something that a lot of us like to think about as a possible alternative, now that we're seeing so much commercial real estate sitting vacant or close to it, I think everyone's realizing that conversions are extremely costly. They take a lot of time. You really got to have all the right pieces in place from a building infrastructure investor and lender standpoint to make that kind of project work. And I think the reality is it's few and far between where you're actually going to be able to pull that off. So yeah, we are honestly starting to hear more people in the industry talking about the fact that we may have to reckon with some obsolescence in terms of the existing buildings, obviously once you sell the property, there's other things that that same piece of property can be used for down the road, but your best option at some point may become to just start over with a new project.

Dominic De Simone :

Ray, I know we're going to talk a little bit later in more detail about enforcement, but I think you had an interesting, two interesting situations that goes to just even just dealing with the borrower on the underlying first mortgage loan and who you're exactly dealing with when there's other parties in the capital stack. Whether it's either preferred equity or a Mezz lender and how that could just simply interfere with your ability to even engage with the borrower under the senior loan. Could you talk a little bit about that?

Raymond Quaglia:

Sure, yeah, absolutely. We've encountered a situation one in particular where we had an experienced borrower and a sophisticated preferred equity investor who had a falling out over certain matters relating to the accounting of cash at the property and the like. And wound up in essentially a two-year battle that wound its way through arbitration and then up on appeal in the district court over essentially who had the right to control the borrower entity. On behalf of the lender we had commenced a foreclosure action really at the outset of this dispute, and essentially were constrained to sit in our hands for the better part of two years while this underlying dispute as to basically who we could speak to who was authorized to speak for the borrower in the foreclosure litigation made its way through arbitration in the courts. So I don't know that that's something necessarily that a first mortgage lender may think of going in, but obviously we've seen firsthand that this could be a significant issue in terms of impacting exercise of remedies.

Dominic De Simone :

Yeah, I thought that was a pretty interesting story and it's a reminder that there are a lot of other potential parties at play here and other potential obligations. So if you're a balance sheet lender and you're the only lender, then maybe you're just looking at the capital stack. Bill, if you're the trustee, you have to think about what the trust agreements say in terms of your authorities. If it's a syndicated deal too, Bill, as you pointed out, what authority does the agent have versus things that require either a majority vote or even a unanimous vote of the lenders special servicers. You have a pooling and servicing agreement. So there are a lot of folks who I think are in positions where there's other considerations that have to be layered across the particulars of the given deal to make sure they're balancing all of their respective obligations.

Brian Schulman:

Dom, I think that's an important point going back to on the CMBS side, who's in control, and I think that's part of the due diligence that ought to be done on the CMBS side upfront. And that goes hand in glove with what Carlo was talking about with getting the appraisal, figuring out who's in controlling position with respect to disposition of the asset.

Dominic De Simone :

Well why don't we move a little bit more into enforcement and Ray, why don't you take us through some of the steps there and some of the potential actions. And realizing that in some cases enforcement doesn't always have to be adversarial in the sense that there's an actual dispute. We have situations where it's consensual to hopefully move the asset along and otherwise resolve it in a way that works for everyone. But if you could take us through that.

Raymond Quaglia:

Absolutely. So office foreclosures are not really different in kind or office enforcement is not really different in kind than other types of enforcement, regardless of the asset class. There's a number of threshold questions. First and foremost, I guess whether you're in a judicial or non-judicial jurisdiction, I practice exclusively in judicial foreclosure states, Pennsylvania, New York, New Jersey. I am envious of some of my colleagues who practice in non-judicial foreclosure states because they can pretty much get a foreclosure done and the property sold and about the time we're taking for this webinar, whereas we're we're sitting on our hands for two years while the pref equity investor fights with the borrower's managing member.

But putting that aside, so once you know where you are and obviously on the judicial side, another threshold question is what's the borrower's position? Is the borrower unable to refinance on a maturity default and ready to hand over the keys, in which case they would typically stipulate or consent to a judgment and the appointment of a receiver, or do they want to hang onto the property for whatever reason or play out for some additional time while they try to sell or get a refinance in place?

Tying back to an earlier issue, we will typically see in the context of asking for a borrower consent, a request for reciprocal release of the guarantor, the guarantors. In the CMBS world, these are all limited recourse guarantees. They're limited as bad act triggers. It is not typically the case, at least in the CMBS special servicer side that the lender will agree to an outright release of the guarantor. I think that the most I have seen in terms of concessions is maybe a limited release carving out bankruptcy environmental claims that would take effect at some period in time after either the appointment of receiver or transfer of title

on the theory that that gives the lender time to assess the property, kick the tires and satisfy themselves that there's nothing amiss here and there would not be a basis for a recourse claim. But certainly this comes up in almost every deal involving request for borrower consent.

When we are moving forward with remedies in court, whether it be consensual or even non-consensual, there's a threshold question of whether to sue in state or federal court. Traditionally, foreclosure is a state court remedy. I know there are plenty of very experienced practitioners who file exclusively in state court. Again, in the CMBS world where you're dealing with national bank trustees, you often have the option of filing in federal court because you have federal diversity jurisdiction. And while I wouldn't speak in absolute terms, there's always a chance you're going to get a better draw on the state side than the federal side. As a general rule, and particularly depending on what state, county or jurisdiction you'd be in, you're often better off proceeding, at least initially in federal court.

And then maybe once you get your judgment assigning or transferring the judgment over to state court to go to a sheriff's sale. But another factor to consider going in. Obviously in conjunction with the foreclosure, we are often asked to pursue a receivership. Receiverships in judicial foreclosure states are difficult when they're contested. It's a very high standard that the lender has to meet. Typically, you're going to have to show waste or mismanagement. The language, merely having good language in your mortgage entitling you to a receiver and or a borrower who is stealing the rents just doesn't move most courts, state or federal in any of the judicial foreclosure states where I practice.

Brian Schulman:

Let me jump in there because as a practitioner and non-judicial foreclosure state, a lot of this depends upon the experience of the judges. So in the early days of the great financial crisis, receiverships were hard to come by because judges didn't know them, they didn't understand them and they had no experience with them. As the crisis spilled out a little bit and they became a lot more common, receivership applications were coming in with regularity, it became much more routine to get your receiverships granted early on. So it does happen and is fairly easy to do that in non-judicial foreclosure states because the deed of trust provides a lot of rights that you don't otherwise have in judicial foreclosure states, but allow you to short circuit the process and I think the courts respect that and they move these things through. Ray, what are your thoughts on what should be in a receivership order? How important are those?

Raymond Quaglia:

Very important. Obviously we tend to have generally form orders we use that have been time tested and adjusted to deal with circumstances over the years. We have a special form of order we'll use for office buildings often since our clients tend to use national very experienced receivers, the receiver will have their own form of order or their own terms that they want to see in the order. So there'll be some harmonization between what we have in our order and what they have in their order and we'll want the receiver to sign off. But generally speaking, you want to give the receiver all of the powers that would be necessary to conduct the operations of managing the office, building of dealing with tenants, with vendors.

Brian Schulman:

What about power of sale?

Raymond Quaglia:

Power of sale is something that the lenders love. In my experience in the judicial states, you're not going to get a power of sale without the active consent of the borrower. And in a state for example, like New York, you're probably not going to want to go for a power of sale at all because the title companies tend to be very skittish about title transferring by receiver sales, particularly in New York. I found them to be a little more amenable to receiver sales in Pennsylvania. And of course there is a federal statute, if you're in federal court, there's actually a federal statute that provides for receiver sales. So you've got kind of a stronger case for a receiver sale in federal court, but generally speaking, if you imagine a contested foreclosure, you're not going to get a court to say while the borrower is contesting whether you have the right to foreclose, we're going to allow your receiver to sell the property to a third party so that if the borrower should prevail at the end, there'll be no property left to recover.

Bill Wassweiler:

I just wanted to say, and I'm glad you asked that question, Brian, because a sale free and clear liens through a receivership has been... It's gaining a lot of popularity because it's so much cheaper than a 363 sale in bankruptcy. And in Minnesota, Ohio. There's other states that we were able to do that, but you are absolutely right. I mean look closely at the receivership statutes because there are some that won't allow it without the consent to the borrower, so it's just effectively consensual. But if you can get them in those receivership orders, they are extremely valuable not only to sell free and clear liens, but obviously that means the receivership property would include any right of redemption.

Brian Schulman:

Now we're talking about sales free and clear, and one of the things that I've seen a lot percolating up lately are deeds in lieu foreclosure. And so I recognize there are differences in the desirability of that between judicial and non-judicial foreclosure states. But what are the group's collective thoughts on deeds in lieu versus receivership sales or trustee sales?

Raymond Quaglia:

We don't generally do not do deeds in lieu where I practice and there tend to be jurisdiction specific reasons for that. In Pennsylvania, doing a deed in lieu through a arcane state tax statute will result in potential exposure for all of the borrower's tax liability, not just real estate taxes or property taxes. In New York, deeds in lieu tend to be more expensive than foreclosures on the transfer tax side. So there are considerations that we face where I practice that makes them generally unappealing to lenders.

Karla Vehrs:

I would agree with that from a Minnesota or Midwestern standpoint as well. There are a lot of benefits that you get by going through the foreclosure process or if you're in a state where you can do it going through a receiver sale. And you really got to be confident that you've got clean title if you're going to be talking about a deed in lieu foreclosure.

Bill Wassweiler:

Well, and the other thing too there we do them a lot, but whether we actually... A lot of times we'll just take a deed in the box and just hold it as part of a terms of forbearance. If we ever do a deed in lieu of foreclosure, we always put anti-merger language in there so that if you get to the point where you want to exercise your rights and you are going to take a fee ownership, you still have a right to foreclose on the mortgage. The mortgage hasn't been merged. I can tell you in the states that I've done it, it will work. But that's one of those things you've got to make sure that you can include anti-merger language and that it would be enforceable. Otherwise, you're right. I mean it's very risky. Any undisclosed liens, any liens out there that you've missed, you're going to take subject to those.

Dominic De Simone :

From where my transactional hat, I've done them, they don't trouble me maybe as much, but Bill's point is critical. Everyone we've done, we've had the anti-merger language. So after you take title, you can essentially foreclose against yourself and clear any liens. We've had to come up in situations where you're about to maybe do a foreclosure and realize some key piece of collateral isn't part of what's been granted to you. Had a situation out west where the liquor license was held by an affiliate was missed. We didn't handle the original loan, was missed When it was originally documented, they had been going back and forth between a foreclosure and a deeded and lieu when they realized if they foreclosed, they would not be getting the liquor license. They went back to a deeded in lieu, put in an assignment of a liquor license agreement in with the papers from the affiliate and the liquor license was assigned as part of the overall transaction.

So there are sometimes imperatives why you might decide, but deeds in lieu require really the utmost level of also cooperation from the borrower. Some of the tax issues that Ray mentioned can be mitigated a little bit with that cooperation. The example I gave with the liquor license is mitigated and that usually comes at a price and that price is usually a pretty full release in exchange for the deed in lieu. But each situation can present differently and you have to go through that analysis and realize

both in terms of the risks we've talked about and what the best go forward strategy is. Once you take over the asset, there's intellectual property sometimes that maybe you haven't quite tied up the way you would like originally that now you're trying to get if you're cooperating with the borrower to just essentially do a transfer and sale. So it definitely is... It's out there. It will continue to be out there and be used in certain circumstances, but it definitely, you need to know what you're doing when it comes to deeds and lieu.

Brian Schulman:

On that point, I'm harkening back again to the due diligence, which I keep getting again and again, which I guess is a pretty good sign of how important it is. It is critical that you understand what your security is. A lot of the times there are ancillary properties or ancillary assets that are essential to the operation of the asset, the primary asset, but that fall outside the security that you have for the loan. And if you are in that situation, you need to know that early. And so one thing I would not assume is that the legal descriptions that no one understands are actually comprehensive and sufficient and cover all of the collateral that you need if you're considering taking over this asset. So another element of due diligence that I think is critical because what you don't want to do is get halfway across the river, realize that your asset does not have some critical component to it required for its operation.

Bill Wassweiler:

Just to bring it back to office buildings so they're a little simpler and more straightforward in terms of the real estate. And so we are seeing a trend of at least in some of these class A deals that they are taking at least a deed in the box as part of the resolution.

Dominic De Simone :

Yeah, and are you certainly getting accommodation pledges as well I think has increased in terms especially in those deals as well, taking a pledge of 100% of the equity interest in the property owning entity as another safeguard. Some folks like to think about it as an expedited means of taking control of the property through taking control of the borrower. Certainly there's some jurisdictions that there's some clogging of the equity of redemption theories out there that can cause somebody to pause before actually going forward with that. So can be a very state specific analysis, but I think folks are trying to figure out how to wrap things up in the most effective, efficient way possible.

Certainly when you're now sitting down talking about some type of restructuring or workout. I just want to spend a couple minutes on guarantor claims and in particular Karla, some piercing theories that I know you and Bill have been involved in. But maybe you start with just again, that assessment of the part of the deal and where sometimes that can lead you and what novel, not so novel theories that sometimes you have to think about that probably a lot of folks enforcing loans don't automatically think about when looking at a transaction.

Karla Vehrs:

Yeah. So this is an important set of considerations, and this is something that we touched on when we were talking about diligence and really keeping your antenna up as to your borrower. And whether your judgment tells you that you have a market problem, a property problem, or a borrower problem. And if your judgment is telling you you may have a borrower problem, there are certain additional steps that are worth taking to just consider what other potential avenues for recovery do we have, especially in light of the fact that property values have taken the hit that they have.

So look, this isn't an area that's likely to be particularly relevant for class A office properties where the owners, where the borrowers are sophisticated entities who have a long history and are generally very trustworthy at what they do. This can be a bigger problem though if you're talking about a class C property or some other type of smaller property where you may have a less sophisticated borrower involved. So again, trusting your judgment on whether there's something they're looking into. You can learn a lot by taking a look at not just financial statements, but also bank statements and making sure that cash has actually been maintained in the way that it should be for the property and under the loan documents. And if you start to see indications that it hasn't been, that can prompt a whole different discussion about other avenues for recovery. So it's really going to depend a lot on your specific loan documents and on specific state law and your facts.

But just by way of example, if you're seeing that you've got a borrower who jointly owns a number of other entities and is regularly commingling funds and pulling funds from one property to prop up another, that kind of conduct can lead to some of these other guarantor claims. Not just under the personal guarantees themselves, but also under... It can be a couple of different legal avenues, fraudulent transfer, fraudulent conveyance statutes, and also veil piercing, which is a concept that allows you to look beyond the entity based on the equities of the situation and try to convince a court that it's not just your one borrower entity, but maybe a parent company or other related companies that should be jointly liable for the same amounts that the borrower is liable for.

Brian Schulman:

To Karla's point, a lot of the times when we see that it's because there are assets that are transferred from the borrower, which is typically an SPE for related entities. Which is typically a guarantor trigger liability trigger under the bad acts carve outs. But when you follow the money or you follow the asset, you can sometimes bring in the assets of that related entity who received that transfer because regularly if a borrower's going to make a transfer of the collateral in contravention of their obligations under the loan docs, they're probably not getting equal consideration back for that or fair consideration back for that transfer.

Dominic De Simone :

Brian, you had a situation that it wasn't so much transferred out but never really withheld from the original transaction. It wasn't an office building situation, but a situation where there were important offsite rights that I think everyone thought were tied up neatly. Again, we didn't close the original loan, but when you got involved in the litigation, realized that there were some key property rights that were outside of the collateral for the loan that prompted you to have to then pursue those assets which were sitting with an affiliate of the sponsor.

Brian Schulman:

There was some critical infrastructure that was not part of the collateral package, which in and of itself didn't trigger the guarantee. I mean, if that happens, it's shame on the underwriting, but it's how the borrower then tried to leverage those assets outside of the collateral pool that really caused some trouble for the borrower and triggered the alter ego liability. In addition to transfers and some other bad acts it was a fulsome effort by the borrower to trigger alter ego liability and the borrower successful in triggering its alter ego liability for all of its related entities.

Dominic De Simone :

So let's maybe go to the other end of this for a few minutes, which is we advise a lot of clients in terms of asset management from really the very beginning through this process to avoid any potential claims lender liability or otherwise. Brian, can you talk a little bit about that area? And I know we advise folks on careful communication and how that sometimes can present that when lenders are really trying to manage these assets and often there's multiple handoffs along the way in the life of the management of the loan that often have to be factored in.

Brian Schulman:

Yeah, so thanks Dom. Let's start off just talking generally about what lender liability is, and we could spend an hour on this topic alone. But lender liability, it's a term that gets bounced around quite a bit, but all it is is a claim by the borrower against a lender claiming some breach of some duty, whether a duty under law or duty under the contract that triggers the lender's liability, claiming that the lender's conduct harm the borrower in some respect. In our experience, the vast majority of lender liability claims that are either asserted informally or asserted in the form of a counterclaim or an actual lawsuit against the lender. The vast majority of them are deployed solely for purposes of getting some leverage against the lender in the negotiations on whatever the resolution of the loan or the asset will be. There's smoke but frequently no fire.

So in my estimation, I'd say probably between 10% to 20% of those claims, the lender has done something that is not good and could subject the lender to liability, but the remaining 80% to 90%, it's purely a leverage play. So when we counsel our lender clients, it's how to eliminate the opportunity for a borrower to find those sorts of points that they can try to exercise for

leverage. And this really goes back to things we were talking about before. I mean, certainly you got to know your loan agreement. You got to know what rights you have under the loan agreement and exercise those rights in accordance with the loan agreement. If you start acting outside the scope of the loan agreement, the rights granted in terms of enforcement, then you're going to have a breach of contract claiming there could be problems. Most of what we see really isn't about the loan agreement itself or breaches of the actual contract.

A lot of the times we see what are called a breach of implied covenant to good faith and fair dealing claims. So in every contract there's an implied covenant of good faith and fair dealing. It's really a gap filler. So where the contract doesn't expressly speak to a particular circumstance, the implied covenant in good faith comes in and it basically says that the parties have to act reasonably in accordance with the other party's expectations under the contract to fill in the gaps. Where that comes in a lot is through the lender's exercise of discretion, which is there's numerable instances in the agreement, loan agreements and loan docs that give the lender a discretion. One of the things that we see quite a bit is, and this is what we counsel, is for the lender to act consistently with respect to the borrower. If there is a change in course, if the lender, for example, is going to waive late payments just on a handshake deal or "No, no, don't worry about it, get it to us later," the borrower can come to rely on that course of dealing.

And if the lender all of a sudden issues a notice of default because the borrower is late with a payment, whereas before the lender just blew it off, the borrower can then say, "Hey, you acted in bad faith. You had loaned me into this impression that this was okay, and now you're changing course on me." So we see that a lot as something that when the relationship between the lender and the borrower starts to deteriorate and the lender starts playing hardball, that's where we see a lot of these claims come up. So in terms of consistency, it's not necessarily a problem that the lender changes course and starts playing hardball. What we would recommend is that the lender tell the borrower that the circumstances changed, that the graces that the lender had previously provided will no longer be provided. And after the lender gives that heads up, then you can start acting more aggressively in terms of your enforcement rights.

The other thing that we see a lot is that the borrower will assert these claims, they'll start taking discovery and there's really not much to the claim. But then when the borrower gets their hand on the loan file and the communications in the emails internally, even externally, there are some things in those loan files, particularly internal communications, that when we see them as litigators and we're representing the lenders, we're like, oh boy, I wish the lender had not said... The asset manager had not communicated to another asset manager, "Boy, this borrower is an idiot," and putting it in an email. So one of the things that you can do that will best protect you from a lender liability claim is pretend your grandmother is reading all of your emails.

Make sure that you are communicating even internally, even it doesn't matter whether it's in text, whether it's in email, whether it's on Slack, any method of communication could be captured typically other than phone calls. You have to make sure that you would be willing to stand by everything and vouch for those communications. So communicate professionally, particularly to your borrower, but even internally, make sure that what you're communicating is accurate and fair, because if it's not, then those emails come up, those communications come up. It makes it a lot easier for a borrower to say, see, the lender had it in for me all the time, and courts do not like unprofessional communications. They do not like communications where a lender, for example, is denigrating a borrower in some respect.

I guess the last thing I would say on lender liability, I welcome anybody else to jump in on this, is if a borrower starts talking in terms of lender liability, it is important that you not as an asset manager, as a lender start freaking out and writing communications internally that are like, oh my god, goddess or whatever, when the borrower starts rattling, lender liability sword, take a deep breath, pick up the phone, call a colleague, a supervisor or manager, call counsel, don't commit to anything in writing, and then come together with a plan with somebody who's more objective on how to respond to the lender liability claim. But do not knee-jerk respond to the borrower who's starting to make that noise. The knee-jerk reactions are typically not the ones that you, upon reflection, would be happy you had made.

Dominic De Simone :

That's great. Thanks, Brian. Appreciate that. Yeah, I think it's an interesting area because I think a lot of the folks that we deal with are certainly the process has a lot of folks who are deal makers, right? They often want to try to solve a particular problem, and I don't think we're suggesting that you can't engage in that manner because I think it isn't important, and we were involved in a lot of deals that wind up with some agree to resolution trying to resolve the situation. So it's not always just

simply adversarial and litigation. But the point that you made, Brian, I think, which is be professional, be clear, be thoughtful in your communication. You can still try to work to resolve a situation without necessarily saying things that may become a problem down the road.

Brian Schulman:

One more thing, I want to just real quick comment on that. I mean, there's this notion that just because you can doesn't mean you should. So I think most lender liability claims are a reaction to something that the lender is doing. A lot of the times these lender liability claims come in response to guarantor enforcement actions where the borrower would otherwise turn over the keys. But when you're going after the sponsors of the guarantor's assets, then all of a sudden there's a whole new ballgame at play. So one of the things I would suggest for all parties is make an objective evaluation about what you hope to obtain through any action you're going to take, because whatever you do is going to provoke a reaction from the other side positively or negatively, and just make sure the juice is worth the squeeze.

Dominic De Simone :

It's great. Well, we're at the end actually, but I wanted just to go around with each of you and just give you 30 seconds maybe for a big picture takeaway or observation that you would want to share. Brian.

Brian Schulman:

Yeah, this is going to sound enormously self-serving but an ounce of prevention is worth a pound of cure. If you have questions on how something is going to play out, whether it's enforcement, due diligence or otherwise, get counsel involved early. Because a lot of the times that what we can do to assist you on the front end actions will save a lot of time and a lot of money on the backend and the investment in talking to council early on is almost always very well worth it.

Dominic De Simone :

Great. Bill.

Bill Wassweiler:

Yeah, this is another one may be kind of obvious, but just know your parties, know your borrower, because when I've talked about a decision tree, who you're dealing with is going to drive everything. And a lot of the deals that I'm working on right now in the Class A space, these are borrowers that have been acting in good faith. These are just maturity defaults because if you can get into some consensual resolution, it's going to save you a lot of money down the road in terms of fees and costs.

Dominic De Simone :

Great. Thanks Bill. Ray.

Raymond Quaglia:

I have been doing commercial litigation for more than 30 years, and in my experience, there is no area of the law that is more jurisdiction specific, exacting an arcane than enforcing remedies against real property. So if you are going to go that route as a lender or servicer, I would strongly suggest that you have local council on the ground who knows their way through the process.

Dominic De Simone :

Thanks Ray. Karla.

Karla Vehrs:

I would add making sure that you have good policies, procedures, and training in place for your whole team early and often. The market environment that we're in right now is unique. Every one of these office properties that we've been talking about is unique and there's a lot of judgment that's involved in understanding how to navigate these different issues. And a lot of the people managing them now have not been through a downturn before. So really making sure that you have your ducks in a row on your internal, within your own house is a great additional measure of protection.

Dominic De Simone :

Great. Thanks Karla. Well, that brings us to the end of the program. I wanted to thank my partners for what I think has been a great discussion. I hope everyone enjoyed the program. We ask you to visit the Ballard Spahr website if you want to learn more about our practices, including our distressed office buildings, team, and also learn about the range of training topics that we offer as well. So thank you very much.

Steve Burkhart:

Thanks again to Dominic De Simone, Brian Schulman, Raymond Quaglia, William Wassweiler, and Karla Vehrs. Make sure to visit our website, www.ballardspahr.com where you can find the latest news and guidance from our attorneys. Subscribe to the show in Apple Podcasts, Google Play, Spotify, or your favorite podcast platform. If you have any questions or suggestions for the show, please email podcast@ballardspahr.com. Stay tuned for a new episode coming soon. Thank you for listening.