SEYFARTH SHAW LLP ATTORNEYS

Real Estate Finance Report

a joint publication of the Structured & Real Estate Finance Group and Distressed Asset Resolution Team of Seyfarth Shaw LLP

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Two Mezzanine Lenders, One Piece of Collateral

By Joseph Manello and Joshua Kurtz

Introduction

In recent years it has become common to see multiple layers of mezzanine debt used by borrowers to "bridge the gap" between equity and debt. Unlike a mortgage loan, which is secured by real property, mezzanine loans are secured by a pledge of the direct or indirect ownership interests in an entity that holds title to real property, typically a limited liability company ("LLC") or a limited partnership ("LP").

By properly structuring a mezzanine loan transaction under the Uniform Commercial Code (the "UCC"), two mezzanine lenders can each perfect their respective security interests in the same equity interests of an LLC or LP by "control." Mezzanine lenders generally prefer to perfect their security interests by control, rather than by other methods of perfection (e.g., by filing) because perfection by control can provide greater benefits to a mezzanine lender with respect to its priority position.[1] Specifically, a mezzanine lender which perfects its security interest in the equity interest of an LLC or LP by control has priority over a secured party that does not have control, even if such party perfects its security interest prior in time.[2]

Perfection by Control

Article 9 of the UCC affords different methods of perfection to secured

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PROCEED WITH CAUTION: Enforcing a Defaulted Loan Within the Framework of California's One Action Rule

By Mark Mengelberg and Anthony Burney

In enforcing its remedies against a defaulting borrower or any guarantors, a real property secured creditor, despite any language to the contrary in the loan documents, must be careful to ensure that its remedies are carried out in a way that does not violate California's anti-deficiency laws. This is especially important in the current market given the precarious situation of many borrowers of real property secured loans. Thus, an understanding of California's anti-deficiency laws is important both in the loan documentation process and in the enforcement of the remedies available to a real property secured creditor. The following provides a general overview of the protections and pitfalls of California's anti-deficiency laws.

I. The One Action Rule.

Section §726(a) of the California Code of Civil Procedure ("CCP"), commonly referred to as the one action rule, encompasses three aspects regarding the enforcement of a real property secured obligation: (i) the security first rule, which prevents a real property secured creditor from ignoring its security and suing on the underlying note or debt;[1] (ii) the one action principle, which requires a real property secured creditor to enforce all of its security in a single action;[2] and (iii) the one form of action rule, which provides that there is only one form of action by which a real property secured creditor can seek to enforce a debt, and that action is by judicial foreclosure.

The security first rule requires a real property secured creditor to first look to the security before it can seek a personal judgment from the debtor. The security first rule can be raised by a debtor at any time during trial, and when a debtor does so, the creditor is required to amend its complaint to include all of the security which secures the debt into one action. Note that a creditor's exercise of its rights pursuant to a statutory banker's lien and a set-off against a bank account[3] violate the security first rule; however, neither the exercise of a creditor's rights under §2938 of the California Civil Code ("CC") (e.g., appointment of a receiver and collection and application of rents), nor the presentment, receipt of payment, or demand for payment under a letter of credit constitute an action for purposes of the one action rule. The second aspect of the one action rule provides that a real property secured creditor must enforce its security in a single "action," which

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Q&A with Terrence Daly from Kearny Capital Partners

By Mark Mengelberg

Mr. Terrence S. Daly is a principal and co-founder of Kearny Capital Partners, a San Francisco-based commercial mortgage brokerage firm. At Kearny, Mr. Daly specializes in placing permanent, bridge, and construction debt, equity and mezzanine capital throughout the United States. Terry received his Juris Doctorate from the University of California, Hastings College of the Law, and practiced real estate law for three years prior to becoming a mortgage broker.

As we all know the financial markets have experienced a tremendous amount of turmoil over the last few quarters, what has been the biggest surprise to you?

A couple of things. First, how quickly the CMBS market shut down. It was not that long ago that we were arranging 10-year full term interest only CMBS loans. Now there is no CMBS market. Second, how patient equity capital has been in 2008. There are many equity funds that have billions of dollars to put out that have remained on the sidelines in 2008. It will be interesting to see how long they sit on the sidelines.

How have deals changed in price structure from the beginning of '07 compared to today (April 2008)?

Universally, lenders want to take less risk and get paid more for it. They want to lend to better borrowers, on higher quality assets in better locations, at lower leverage and higher spreads than one year ago. Last year, we arranged 90% loan-to-cost (LTC), non-recourse, bridge loans at 200/LIBOR spreads. Today, the same loans are 65%-70% LTC, at 350/LIBOR spreads. In addition, bridge lenders want break even cash flow at close as opposed to 12 months ago where they were lending on non-cash flowing assets. On the fixed rate side, a year ago we arranged 10-year interest only, non-recourse loans at 1.05x DSCR on interest only constants at 100/Treasury spreads. Today, the same loans are at a 1.20x DSCR on an amortizing constant at a 300/Treasury spread with no interest only. One other major change is that a year ago it was actually easier to finance large loans than smaller loans. This year most lenders will not lend above $50 million without a participant and it is hard enough to convince one lender to finance your loan, let alone two.

Everyone seems to differ on their forecast of when we'll actually emerge from the current market situation. What differences, if any, have you seen from the end of Q4 of 2007 to today (April 2008)?

Liquidity seems to be creeping back into the market. CMBS paper is attracting buyers again. In late 2007 there were no buyers, even for AAA paper. Recently, however, JPMorgan sold all the tranches of its latest pool, which is a good sign. The AAAs traded at 167 bps. A month before that, AAAs were trading at 225 bps. CMBS spreads are still high, but they seem to be moving in the right direction. In addition, there has not been a deterioration in commercial real estate fundamentals which remain strong.

As right now (April 2008), which loans are getting done and which are not?

The most difficult deals to finance right now are land deals, any for-sale product (whether it's commercial condo or residential), hotels and single tenant, non-credit transactions. In general, lenders don't want to lend on "story deals" or deals with "hair" on them. The product type that has been least affected by the "credit crunch" is multi-family. The agencies are actively quoting full leverage deals (75-80% LTV), 10-year, non-recourse loans with interest only at competitive rates. In addition, bridge lenders will lend 5%-10% more in the capital stack at spreads that are 50-100 bps lower for multi-family than other product types.

There was a general impression that as the CMBS market experienced problems that life companies and other balance sheet lenders would step in and fill the void left by CMBS lenders. Has that happened?

No, many people had hoped life companies would fill the CMBS void but it has not happened. Life companies have not really increased their allocation to real estate. In fact, some life companies have stopped originating whole loans altogether, choosing instead to buy higher yielding CMBS paper. If anything, life companies have become even more conservative in their underwriting. They are lending at lower leverage and higher coverages than a year ago, but because of the lack of capital in the market they are able to charge higher spreads and still get their money out the door. There is even a concern that many life companies will burn through most of their allocations by the middle part of this year and have nothing left for the 3rd and 4th quarters. The local and regional banks have actually done more to pick up the slack from the CMBS market than the life companies, lending on deals that last year would have been CMBS loans. However, those deals are at lower leverage and generally have a recourse component. Whether because there is pressure from the regulators or because they don't have to, the banks that were making non-recourse loans earlier in the year seem to be requiring full or partial recourse today.

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Dealmaker Summaries

The following are descriptions of just a few of the recent transactions handled by SREF attorneys:

Boston office closes multiple golf course deal. A team led by **Andrew Pearlstein** and **Sean O'Brien** represented the lender in a $38 million refinancing of four golf courses in New Jersey. The client required a capital markets-friendly loan structure because of their exit strategy, which involved selling a participation interest in the loan to a purchaser that is only interested in loans that comply with S&P's U.S. CMBS guidelines. So each golf course was owned by a separate "bankruptcy-remote" limited liability company. Another key consideration in structuring the transaction was that the operator of the food and beverage operations at each golf course held a full liquor license, which added significant value to the collateral package. "We had to develop a structure that gave the lender maximum flexibility in enforcing the loan in a way that would minimize the risk of losing the liquor licenses," noted **Sean O'Brien**. The structure involved each operator entering into a lease for the restaurant and bar operations and having those leases assigned to the lender. Each lease remained senior to the mortgage, but the lender had the right to either terminate any lease or succeed to any landlord's interest under any lease if an event of default occurred. The lender also took a pledge of the beneficial interests in each operator so the lender could also foreclose on each such mezzanine position and take over the operator.

Washington, D.C. apartment portfolio recapitalization. A team led by **Adam Walsh** and **Stan Jutkowitz** of the Washington, D.C. office recently closed an equity recapitalization of three apartment complexes located in the Washington, D.C. metro area collectively valued in excess of $90 million. Seyfarth Shaw represented the existing owner of the apartment complexes, whose new equity partner is a Texas-based pension fund. The deal was complicated because each property was encumbered by separate securitized debt that was remaining in place. As such, the recapitalization was subject to the approval of multiple servicers, sub-servicers and certificate holders. One particular area of concern for all parties was that, as an exit strategy, the equity partner insisted on having a "buy-sell" right to purchase the remaining equity upon the occurrence of certain project-related events, without any further lender consent. However, the equity partner refused to provide a replacement guaranty should it exercise the buy-sell and instead wanted the lenders to rely solely on the existing guaranty executed by the sponsor. The lenders rejected this approach because the sponsor would be effectively removed from ownership and management upon exercise of the buy-sell and, in the current lending environment, lenders are hesitant to rely solely on carve-out guarantors that do not have control of the

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Message From The Chairs

Peter Korda

Andrew Pearlstein

Welcome to the inaugural issue of Seyfarth Shaw's Real Estate Finance Report, the quarterly newsletter of the Structured and Real Estate Finance Group (SREF) and the Distressed Asset Resolution Team (DART) of Seyfarth Shaw LLP. We have long believed that our time (which, of course, is our principal resource) is best devoted to supporting our individual clients' programs and goals. In looking for an efficient and informative way to reach our clients and friends at one time with topics of general interest and matters of timely importance, we readily determined that a newsletter format was the answer. Therefore, thanks in large part to our editor, Mark Mengelberg, whose considered observations and persistent efforts were key to the launch of the newsletter, and to Frank Johnson, our group marketing manager, we went to press. A few words about the commercial real estate lending marketplace:

Few sectors of the lending community are untouched by current conditions. We're always impressed by the manner in which the community works to adjust and learn from market experience. As with much learning under difficult circumstances, some of it is just plain painful as many individuals and companies suffer adverse news and significant challenges. We do not know how long the downturn will last or how many of the recent vintage loans will default or when investors may emerge or return. We do sense an increased aura of readiness in the community to deal with the problems and move forward. It is with this mix of realism and optimism that we offer our first newsletter. This first edition offers assistance to real estate lenders providing funding for California properties by seeking to clarify the well known, but still not well understood, "one-action rule." We also seek to clarify one of the hottest areas in real estate finance, mezzanine financing, by discussing the perfection of security interests in mezz collateral. From a different perspective, more than a year ago, SREF, concerned by the overheated real estate market, created a workout/enforcement group. This group joined with members of the bankruptcy, litigation, tax and environmental groups to form DART. The DART section of the newsletter presents an article addressing the effectiveness of a borrower's waiver of the Bankruptcy Code's automatic stay provisions. Finally, believing that our newsletter should also be a forum for the expression of different viewpoints, from time to time we will have guest contributors or conduct market interviews. In this issue, we spoke with Terrence Daly from Kearny Capital Partners, who speaks candidly on which deals are being financed in the current market and on what terms. Finally, in our Dealmaker Summaries we have included some very useful insights on recent transactions that have been handled by SREF and DART attorneys. We hope you enjoy this newsletter, and we look forward to your comments and suggestions (which, if highly complimentary, we may print).

Bankruptcy Court Approves Pre-petition Automatic Stay Waiver *By William Factor*

In *re Bryan Road, LLC,* 2008 WL 376773 (Bankr. S.D. Fla. 2008), the Bankruptcy Court for the Southern District of Florida concluded on February 12, 2008, that a borrower could and did waive the protections of the Bankruptcy Code's automatic stay in a pre-bankruptcy workout agreement with its lender and thus lifted the stay to enable the lender to hold a foreclosure sale.

The borrower was obligated to the lender for almost $9 million on account of a loan that was used to finance the development of a warehouse-type building containing some 210 boat storage spaces, each of which was a separate condominium unit offered for sale to the public. In 2006, the lender filed a foreclosure action in state court after the borrower failed to make required principal and interest payments. On the morning of the foreclosure sale, the borrower and the bank entered into a forbearance agreement that extended the date of the foreclosure sale by 60 days to give the borrower an opportunity to close a refinancing that would repay the lender and further provided, among other things, that the bank would be accorded relief from the Bankruptcy Code's automatic stay provisions if the borrower filed for bankruptcy protection. The anticipated refinancing did not occur and the bank was poised to resume the foreclosure sale, until the day before that event when the borrower filed bankruptcy. About two weeks later the lender filed a motion for relief from the automatic stay in order to resume the foreclosure sale.

The Bankruptcy Court ultimately granted stay relief. In fact, because that analysis essentially concluded the borrower could not confirm a reorganization plan, the decision does not provide a clear message about the enforceability of stay waivers as a matter of law. Opponents of stay waivers are likely to contend the stay waiver in *Bryan Road* was of limited value and the stay would have been lifted even without it. Nonetheless, there are several messages that can be gleaned from the Bankruptcy Court's reasoning.

First, the Bankruptcy Court expressly acknowledged what many practitioners generally understand to be the law on this topic, namely, that "prepetition waivers of stay relief will be given no particular effect as part of initial loan documents," but that they may be enforceable when part of a loan workout agreement, and "they will be given the greatest effect if entered into during the course of prior (and subsequently aborted) Chapter 11 proceedings."

Second, the following factors are relevant, although not dispositive, in determining whether to enforce a prepetition waiver: (1) the sophistication of the party making the waiver; (2) the consideration for the waiver, including the creditor's risk and the length of time the waiver covers; (3) whether other parties are affected, including unsecured creditors and junior lienholders; and (4) the feasibility of the debtor's plan.

Third, the Bankruptcy Court focused most of its attention on the fourth factor – the feasibility of a plan – and essentially went through a fairly extensive analysis of the borrower's proposal for emerging from bankruptcy with a confirmed plan. The Bankruptcy Court found the borrower's property was worth substantially less than the value the borrower's expert reached and that the borrower's reorganization plan was predicated upon bringing and winning litigation against various claimants. In many respects, the Bankruptcy Court performed the routine inquiry that occurs when a lender seeks relief from the stay on the grounds the debtor lacks equity and cannot reorganize and is not seeking to enforce a stay waiver.

Fourth, *Bryan Road's* message is that the enforceability of a stay waiver in a pre-petition agreement depends, in part, on whether the debtor can sufficiently establish that it will be able to confirm a plan. Because the borrower failed to meet that burden, the Bankruptcy Court found the pre-petition waiver was enforceable. As the Bankruptcy Court ultimately concluded: "Since under the circumstances of this case the Forbearance Agreement is enforceable, it is apparent to me that there is sufficient cause to grant the Bank the relief it seeks."

Finally, *Bryan Road* helps to bridge the gap between cases in the Second and Third Circuit that have frowned upon stay waivers and cases from other courts that have enforced them. It does that by melding a conventional stay relief analysis into the evaluation of whether a stay waiver is enforceable.

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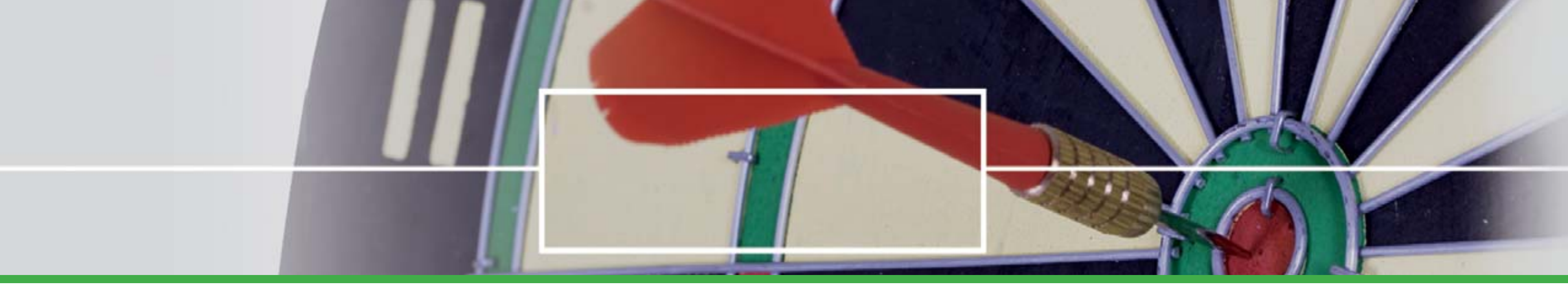

DART Members Win One for Lenders in the Eleventh Circuit *By Craig Pendergrast and Paul Baisier*

DART team members Craig Pendergrast and Paul Baisier recently won an important victory for mortgage lenders in the United States Court of Appeals for the Eleventh Circuit. *Gordon v. Novastar Mortgage, Inc. (In re Hedrick)* and *Gordon v. ABN AMRO Mortgage Group, Inc. (In re Sharma)*, Case No. 07-11179. In these consolidated appeals, the Eleventh Circuit held that a refinancing mortgage recorded outside the statutory ten (10) day safe harbor of 11 USC 547(e)(2) and within ninety (90) days of a bankruptcy filing by the mortgagor could not be avoided as a preference under 11 USC 547 because the mortgages were protected by the doctrine of "equitable subrogation" and the "substantially contemporaneous exchange" defense of 11 USC 547(c)(1).

Both cases involved the same general facts: a lender closed a refinancing mortgage loan, waited for the three-day federal rescission period to expire, promptly sent out payoffs on the existing mortgages, and promptly sent its mortgages to the appropriate offices for recording. In both cases, it took more than ten days from the date of closing for the mortgages to be recorded, and the mortgages were recorded within 90 days of a bankruptcy filing by the mortagor. Both mortgages were also recorded prior to the recordation of satisfactions of the mortgages they refinanced, such that at all times the relevant real property was subject to at least one unsatisfied mortgage of record.

At issue was the application of the doctrine of equitable subrogation in the context of 11 USC 547. 11 USC 547(e)(2) provided (at the relevant time) that a transfer is "made" for 11 USC 547 purposes when it takes effect between the parties, so long as is "perfected" within 10 days after such time. 11 USC 547(e)(1) provided that a transfer is "perfected" when a bona fide purchaser cannot acquire an interest that is superior to the interest of the transferee.

In the *Hedrick* appeal, when the transfer was "made" was critical, because the loan was closed well outside the 90 day preference period, so that if the transfer of the mortgage interest was "made" at or near the time the loan was closed, the transfer did not occur during the 90 day preference period and thus could not be avoided. More specifically, in *Hedrick*, the loan was closed on December 4, the prior loans were paid off on December 12, the mortgage was recorded on January 7, the 90th day prior to bankruptcy filing was January 6, and the prior mortgages were satisfied on January 22.

Under those facts, the Eleventh Circuit held, under the doctrine of equitable subrogation, that the transfer was "perfected" at the time the prior loans were paid off (December 12), because at no time thereafter could a bona fide purchaser have trumped the interest of the mortgagee. That occurred within 10 days of the December 4 closing, such that the transfer was deemed "made" when it took effect between the parties (i.e. December 4). As that date was more than 90 days prior to the bankruptcy filing, the mortgage could not be avoided.

In *Sharma*, all the relevant events occurred within the preference period. The loan was closed on May 20, the prior loans were paid off on May 28, the mortgage was recorded on June 10, the bankruptcy was filed on June 18, and the prior mortgages were satisfied of record thereafter. Based on those facts, the Eleventh Circuit held that the transfer was perfected on May 28. It then went on to find that the "substantially contemporaneous exchange" defense was not precluded by the existence of 11 USC 547(e), as some other court has held, and that application of that defense preventing the avoidance of the mortgage because the mortgage was intended by the parties to be a contemporaneous exchange for new value and was in fact such an exchange.

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What is DART?

The **Distressed Asset Resolution Team** (DART) is a dedicated interdepartmental team that specializes in real estate loan restructures and related bankruptcy matters, foreclosure actions and the exercise of other loan document and state law remedies. Members of DART are drawn from several practice areas, including structured and real estate finance, bankruptcy, real estate litigation, tax, ERISA, environmental and construction.

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is generally defined as a judicial proceeding prosecuted to judgment or the judicial or non-judicial appropriation of the debtor's non-collateral assets. Examples of nonjudicial appropriation which violate the one action rule include: prejudgment attachment of noncollateral assets of the debtor; and prejudgment attachment on a bank account. For purposes of the one action rule, neither non-judicial foreclosure nor the *commencement* of judicial foreclosure are considered an "action" within the meaning of CCP §§22 or 726(a), since neither have been reduced to a judgment. In a loan secured by both real property and personal property, creditors are permitted to foreclose on any personal property secured by the creditor pursuant to Section 9604 of the California Commercial Code without violating the one action rule.[4] Note that since non-judicial foreclosure is not an action within the meaning of the one action rule, a creditor can conduct separate, piecemeal non-judicial foreclosure proceedings if the creditor did not originally include all of the security in the original non-judicial foreclosure or where multiple security is used for a single note. The final aspect of the one action rule provides that judicial foreclosure is the sole action by which a real property secured creditor can enforce its security.[5] Once the creditor has completed judicial foreclosure proceedings, the creditor is deemed to have made an election of remedies and waived any security for the loan that was not included in the action.

Violations of the one action rule typically occur when a creditor (i) proceeds directly on the note before foreclosing on the security and obtains a judgment, (ii) fails to include all of the security in a judicial foreclosure action and following a judgment attempts to enforce the remainder of the security, or (iii) exercises self-help remedies after a debtor's default (e.g., setoff against a bank account, exercise of banker's lien or appropriation of unpledged assets). As noted above, a debtor can raise the security first rule as a defense and require a creditor to amend its complaint to include all of the security before proceeding directly on the note. However, even if a debtor fails to timely raise the security first rule as a defense, the one action rule will still operate as a sanction. Historically, courts held that both the underlying debt and the security would be waived for violation of the one action rule. However, absent certain conduct by the creditor (e.g., the creditor's refusal to restore funds offset by the creditor after the debtor's demand), the more recent trend has been to waive only the security and to keep the debtor obligated on the underlying debt.

The one action rule is inapplicable in certain situations, entitling a creditor to enforce its security without first instituting foreclosure proceedings. Exceptions to the one action rule include: (i) CCP §726.5, which allows a creditor to waive its lien for environmentally impaired real property and instead sue the borrower directly on the note (as if the lender were an unsecured creditor) provided that (a) the borrower knows of or caused the impairment, (b) notice of default has been given, (c) a court has confirmed that the real property is environmentally impaired, (d) the creditor has foreclosed on all other security held by the creditor, and (e) the property is commercial property or over 15 residential units;[6] (ii) legally worthless security (e.g., real property that does not exist, cannot be mortgaged, is not owned by the trustor, or cannot be encumbered by the debtor); (iii) sold-out junior creditors (e.g., a junior creditor who has had its security extinguished when a senior creditor forecloses on the senior lien is not subject to the one action rule and may proceed directly against the borrower on the note); and (iv) rent skimming (e.g., the lender can come after the borrower to the extent of misappropriated rents upon the borrower's default).

In addition to the foregoing exceptions to the one action rule, CCP §736 allows a lender to bring an action for money damages for breach of contract against the borrower if the borrower has violated any environmental provision in the loan documents, notwithstanding CCP §726.[7] The requirements of bringing an action under CCP §736 are similar to the requirements noted above under CCP §726.5, except that to bring to an action under CCP §736 (i) the original loan amount must have been greater than $200,000 and (ii) the creditor is not required to sue first and prove the impairment or foreclose first on other security held by the creditor. Amounts recoverable under CCP §736 include (a) all amounts reasonably expended in connection with the cleanup costs if ordered by a governmental agency, or if not ordered by a governmental agency, amounts which are reasonable and made in good faith, (b) indemnification against all third parties provided that the creditor is not responsible for the impairment of the property, and (c) attorneys' fees and costs incurred by the creditor relating to the breach.

II. Judicial Foreclosure v. Non-Judicial Foreclosure.

Typically, judicial foreclosure and non-judicial foreclosure are commenced simultaneously, with the creditor dismissing one of the two foreclosure proceedings once the creditor has weighed the advantages and disadvantages of each process. Another reason for instituting both proceedings simultaneously is that a creditor can apply for the court to appoint a receiver in a judicial foreclosure action, but may not do so in a non-judicial foreclosure proceeding because such proceeding is conducted outside of the court. The primary advantage of instituting a judicial foreclosure action is that, except for purchase money loans, a deficiency judgment is permitted after a judicial foreclo-

sure to the extent the borrower is liable for a deficiency under the terms of the loan documents. If the creditor is entitled to a deficiency judgment, the creditor must apply for the deficiency amount within three months following the foreclosure sale. However, under the fair value limitations set forth in CCP §726(b), a deficiency judgment is limited to the outstanding amount of the debt (plus interest and costs) less the greater of (a) the "fair value" of the property as determined by the court or (b) the foreclosure sale price. Theoretically, if the action is uncontested, a judicial foreclosure action may be completed in as little as three months. However, as a result of delays for calendaring in the local courts and the typical defenses raised by borrowers, the judicial foreclosure process usually takes up to a year or more.

Despite the prospect of obtaining a deficiency judgment, judicial foreclosure is rarely used by creditors in California primarily because (i) the debtor of judicially foreclosed property has a right to redeem the property until one year following the foreclosure if the proceeds from the foreclosure are insufficient to satisfy the indebtedness, plus interest and costs (or three months following foreclosure if the proceeds from the foreclosure are sufficient to satisfy the indebtedness, plus interest and costs); and during the applicable redemption period the debtor may continue to occupy the foreclosed property, unless the lender has waived a deficiency judgment, in which case the borrower does not have a redemption period following judicial foreclosure; (ii) a judicial foreclosure invariably takes longer and is more expensive than a nonjudicial foreclosure; and (iii) a judicial foreclosure must be commenced within four years from the maturity date of the debt or if the maturity date is accelerated, within fours years after the accelerated due date.

The advantages to non-judicial foreclosure are: (i) it is less expensive since its does not involve courts and instead uses the power of sale clause in the deed of trust; (ii) it is a relatively quick process that can be completed within four months (assuming the debtor does not contest); (iii) there is no statute of limitations within which the creditor must commence non-judicial foreclosure; and (iv) there is no redemption period following the sale of the property. The primary disadvantage to non-judicial foreclosure is that a deficiency judgment is prohibited against the borrower, subject to a few limited exceptions.

III. Guaranties.

A. Generally. A true guaranty is one in which a party promises to pay for or pledges collateral for the debt of *another.*[8] While guarantors have the same protections that a surety is entitled to under CC §§2787 to 2855, the one action rule and the anti-deficiency laws are primarily for the benefit of debtors and are not applicable to guarantors. However, courts have found that in some instances, the anti-deficiency laws provide indirect protection to guarantors based on theories of estoppel[9] and certain other defenses provided in CC §§2787 to 2855.

Prior to the decision rendered in *Bank of S. Cal. v. Dombrow,*[10] it was long held that guarantors were not entitled to the benefits of the anti-deficiency laws. However, the *Dombrow* court held that under CCP §580a guarantors were entitled to a fair value hearing following a non-judicial foreclosure for purposes of determining the deficiency amount owed by the guarantors. While acknowledging that this newly afforded protection to guarantors could be waived, the court found that no such waiver existed. Within a few months after it was decided, *Dombrow* was ordered depublished and not citable, but has not yet been overruled. With the depublishing of *Dombrow*, there is still no reported case in California that provides guarantors with the right to a fair value hearing following a non-judicial foreclosure; however, it would be prudent practice for a creditor to assume that guarantors are entitled to the protection of CCP §580a and in response obtain the requisite waivers discussed in Paragraph III.C. below. By obtaining the appropriate waivers, a guarantor would be liable for the entire deficiency amount following a non-judicial foreclosure.

B. Sham Guaranty. A "sham guaranty" is a guaranty executed by a party who is already obligated on the guaranteed obligation. The most common situation in which a sham guaranty arises is when the guarantor is really the debtor in disguise. In determining whether a sham guaranty exists, courts generally look at whether the guaranty was executed by parties otherwise subject to unlimited liability and/or whether the guarantor is the alter ego of the borrower (e.g., where individual partners executed guarantees of a partnership debt, or where a corporation was formed to borrow money and the corporation's debt is guaranteed by the sole or principal shareholders of the corporation which is the debtor). Sham guarantees are unenforceable and, since the party executing the sham guaranty is considered a primary obligor of the debt, the "guarantor" of a sham guaranty is entitled to the same one action and antideficiency protections as a debtor.

Additional factors that courts have looked at in determining whether a true guaranty exists are: (i) whether the lender insisted on the creation of the entity in order to deprive the borrower of California's anti-deficiency protections; (ii) whether the

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lender reviewed only the financial information of the guarantor in making the loan and did not rely on the financial information of the borrower; and (iii) whether the guarantors, or some of them, are the alter egos of the thinly capitalized general partner of the borrower.

While there are no reported California decisions considering the liability of a guarantor that is the sole member of a single member limited liability company borrower where anti-deficiency or one action principles are at issue, the case law is clear that courts will look at the purpose and effect of the transaction to determine whether the supposed guarantors are really the principal debtors under another name. If the structure of the transaction is designed to subvert the purpose of the anti-deficiency laws by relegating the true principal to the position of guarantor, courts are likely to find that a "true" guaranty does not exist and will afford the purported guarantor all the protections of the anti-deficiency laws. To date though, courts have respected the typical structure of CMBS and other loans where the lender requires the borrower to be a single asset entity for securitization and bankruptcy remoteness purposes, but then also obtains certain guaranties and indemnities from one or more of the owners of that single asset entity.

C. Waivers. CC §2856 states the suretyship defenses that a guarantor may waive under California law, which includes defenses resulting from the lender's election of remedies, any anti-deficiency and one action protections a guarantor may have under CCP §§580a (fair value limitation for non-judicial foreclosure), 580b (no deficiency judgment on any purchase money loan or loan secured by owner-occupied one- to four-family dwelling), 580d (no deficiency judgment after non-judicial foreclosure) and 726 (one action rule).[11] However, for many years lenders were uncertain about how to actually craft the language in their loan documents to effectively waive such defenses. The holdings in two different cases in the mid-1990s further muddied the waters on this point. First, the court in *Cathay Bank v. Lee* held that the waiver must expressly state that (i) the destruction of subrogation rights creates a defense to a deficiency judgment and (ii) the guarantor is knowingly waiving that specific defense (i.e., the "Gradsky defense").[12] Then the court in *Bank of S. Cal. v. Dombrow* held that guarantors were entitled to the fair market value protections of CCP §580a.[13] In response to these cases, many institutional lenders modified the waiver language in their guaranties to provide a lengthy explanation of every possible defense that the guarantor was waiving as well as a virtual treatise on the California case law dealing with such defenses.

In 1996 the California legislature stepped in and revised CC §2856 to include two "model waivers" (CC §§2856(c) and (d)) for a lender to include in a guaranty that are adequate to waive any rights a guarantor may have with respect to the following: (i) subrogation, reimbursement, indemnification and contribution; (ii) a creditor's election of remedies; and (iii) the protections of CCP §§580a, 580b, 580d and 726. While CC §§2856(c) and (d) are merely "model" waivers and CC §2856(a)(3) specifically states that no particular language is required to effectively waive the foregoing protections, use of the model waivers verbatim in a lender's loan documents is strongly advised. Still, even with the model waivers, many lenders use belts and suspenders in their waiver language by continuing to include lengthy "Gradsky" type waiver language in addition to the model waivers.

A lender that includes the waivers set forth in CC §§2856(c) and (d) (or variations thereof) in a guaranty, may either (i) sue a guarantor first for the outstanding amount of the debt without looking to the collateral pledged by the debtor, or (ii) foreclose on the real property either judicially or non-judicially and afterwards collect from the guarantor the difference between the debt and the sale price of the real property. If the creditor sues first on the guaranty prior to foreclosure, the creditor still has its remedies of judicial or non-judicial foreclosure against the debtor if the suit against the guarantor has not satisfied the debt because (a) the one action rule is not applicable to a suit by a creditor against a guarantor, and (b) CCP §580(d) only prohibits actions on a "note," rather than a guaranty. If the creditor elects to judicially foreclose and seeks to collect any deficiency from the guarantor, the creditor should add the guarantor as a party to the judicial foreclosure action.

IV. Conclusion.

The one action rule requires that a creditor must look to all of its security before it may sue the borrower on the underlying debt. In looking to the security, a creditor must be careful not to perform certain acts that would constitute an action for purposes of the one action rule since doing so might result in the loss of the security. In enforcing its security, a creditor is generally entitled to a deficiency judgment following a judicial foreclosure, but generally is not entitled to a deficiency judgment following a non-judicial foreclosure. Real property secured creditors who obtain guaranties must also be careful to structure the guaranty so that it is an enforceable guaranty, rather than a sham guaranty. While guarantors are not directly entitled to the benefits of the one action rule or the anti-defi-

ciency protections, it is nonetheless important that creditors obtain the appropriate waivers from a guarantor in light of the willingness of some courts to look past the plain language of CC §2856 and exonerate guarantors in certain circumstances.

The preceding is an abridged version of this article. Please contact the authors directly for a copy of the complete article, including extensive statutory and case citations.

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1. *Walker v. Community Bank*, 10 Cal 3d 729, 733-34 (1974).
2. Cal. Civ. Proc. Code §726(a).
3. *Security Pacific National Bank v. Wozab*, 51 Cal. 3d 991, 998-999 (1990).
4. Cal. Comm. Code §9604(a). Our discussion of a creditor's remedies in connection with a mixed collateral foreclosure is only intended to provide a general overview of the subject and practitioners should carefully review the mixed collateral statute in Cal. Comm. Code §9604.
5. Cal. Civ. Proc. Code §726(a); note again that non-judicial foreclosure does not constitute an "action."
6. Cal. Civ. Proc. Code §726.5.
7. Cal. Civ. Proc. Code §736.
8. Cal. Civ. Code §2787.
9. *Union Bank v. Gradsky*, 265 Cal. App. 2d 40, 44-47 (1968)
10. *Bank of Southern California v. Dombrow*, (ordered not published March 14, 1996; former opinion at 39 Cal. App. 4th 1457 (1995)).
11. Cal. Civ. Code §2856(a)(3).
12. *Cathay Bank v. Lee*, 14 Cal. App. 4th 1533 (1993).
13. *Supra* note 12.

Q&A continued from Page 2

What lending or underwriting practices that were being utilized at the height of the last cycle are we unlikely to see again?

There are many underwriting practices that we will not see again (or at least not in the near future) including (1) the master leases, (2) full term interest only loans, (3) minimum DSCR based off of interest only loan constants, (4) underwriting future rent growth today or (5) unrealistic tenant improvement assumptions. For instance, last year we arranged a loan where the lender held back $5/SF for tenant improvements even though the client budgeted $50/SF to re-tenant the building. Fixed rate lenders have already gone back to underwriting actual in place cash flow and requiring a 1.20x DSCR using the actual interest rate on an amortizing constant. It would not surprise me if CMBS lenders return to an artificial loan constant, like the old 10.09% at a breakeven, which was what they used back in 2002.

Many investors are trying to find opportunity in this market by purchasing distressed loans. Have you seen very many "distressed" borrowers in this market or investors that are actually executing on purchasing those distressed loans?

There are some high profile cases of distressed borrowers, but those are the exception, not the rule. For the most part, real estate fundamentals remain strong. In fact, CMBS default rates are at record lows. There is, however, distress in the capital markets. So it's really a situation of "distressed" lenders, not borrowers, that we are currently seeing. Lenders have loans on their balance sheets that are mispriced and they will sell those loans at a discount. The note sales we have seen seem to be around $.90 on the dollar, which essentially marks the note to market or slightly above market. However, for the buyers of these notes to receive the mid- to high-teens yield that they require, they need to either buy at a greater discount than what is currently being offered or leverage the acquisition. Currently, lenders are reluctant to lower their price and debt is not readily available to finance note sales. So we are not seeing too many note purchases actually taking place. Time will tell if this changes.

Based on the types of deals that you saw over the last five years or so, when do you think that the height of the distress will occur for borrowers, if at all?

I think we're going to see distress on transitional, "value add" assets that were bought in late 2006 or afterward. Buyers who bought property before then probably have a basis that is low enough to allow them to refinance or sell (assuming that they have not already flipped their properties for a profit). The sponsors that bought at the end 2006 or later, however, purchased their properties at or near the top of the market. Furthermore, a lot of sponsors used high leverage (80%-90% LTC), floating rate, 3 year bridge loans to finance these acquisitions. Those loans will start to mature in late 2009. Because of the capital crunch, borrowers will not be able to refinance these loans. Borrowers will not wait until the loan matures to figure this out. So I think you will start seeing activity in this sector in late 2008 and early 2009.

Dealmaker Summaries continued from Page 3

underlying projects. This proposed approach was not ideal for the sponsor either, as it would involve ongoing liability to the lenders despite being removed from control. "After lengthy negotiations with the various parties, we were able to help fashion a compromise that was acceptable to all," said **Adam Walsh**. The compromise involved the lenders agreeing to pre-approve the buy-sell and rely on the existing guarantors in such event, but only if the project was then performing above a certain debt service coverage ratio. This approach gave the lenders comfort that the buy-sell would only be exercised under circumstances where guarantor liability was not likely to be relevant. To address the sponsor's concerns, the equity partner agreed that in order to exercise the buy-sell, it would have to go back to the lenders at that time and obtain a release of the existing guarantors or, if unsuccessful in obtaining a release, it would provide a letter of credit in favor of the existing guarantors in an amount equal to the maximum amount for which the existing guarantors could be liable under the carve-outs. This was acceptable to the equity partner, because it provided an exit strategy without any potential personal liability, which was its prime objective.

New York office closes on financing of nine-property portfolio in Texas. A team lead by **Peter Korda**, **Willard Moore** and **Arren Goldman** of the New York office represented an institutional client in connection with a $26 million loan, the proceeds of which were used by the borrower to acquire nine properties located in Texas over the course of several months. "We addressed a number of interesting legal issues arising from the crossed financing of a number of properties over a period of time," noted **Peter Korda**. One such issue is maximizing title insurance coverage. The client obtained separate policies for each closing, but, following acquisition of the last property, it obtained a single policy covering all nine properties. "This allowed the client to essentially receive title insurance coverage for each property up to the fair market value of each property, when typically the amount of coverage for a lender's policy is tied to the loan amount, which of course is typically 30% to 40% less than the fair market value of the property," said **Arren Goldman**. "Another issue we encountered was that, in order to accommodate the lender's underwriting requirements, the borrower's timing, and Texas practice, we recorded a master deed of trust at the first closing and proceeded to spread the lien at each subsequent closing through the use of supplemental deeds of trust," noted **Willard Moore**.

New York office closes on financing for reverse 1031 exchange. **Mitchell Kaplan**, **Gilbert Rotkin** and **Melissa Kishel** of the New York office represented a lender in an acquisition loan to tenants-in-common as part of a reverse IRC section 1031 exchange. Additional credit support in the form of a full payment guaranty was obtained by the lender and was released only upon the transfer of the tenant-in-common interests from the qualified intermediary to the sponsor to complete the reverse 1031 exchange. In addition to being secured by a first mortgage lien encumbering the acquired property, the loan was further secured by pledges of cash flow and other rights with respect to unrelated assets, which pledges were subordinate to an existing mezzanine loan facility. With respect to the additional pledges, "We had to be mindful of the due on sale/encumbrance provision of the existing senior mezzanine loan that had been securitized," stated **Mitchell Kaplan**. "In order to address this issue, we obtained an immediate pledge of 49% of the membership interests and all economic interests in the pledgor's capital and all profits and distributions to which the pledgor would be entitled, as well as a springing pledge of the remaining 51% membership interests that would only be effective upon the repayment of the senior mezzanine loan, all of which were permitted under the terms of the senior mezzanine loan."

New York office represents purchaser of $300 million pari-pasu senior participation interest. A team led by **Mitchell Kaplan** and **Willard Moore** of the New York office represented the purchaser of an approximate $300 million pari-pasu senior participation interest in a $700 million mortgage loan secured by a portfolio of office properties. The properties also supported several levels of mezzanine debt aggregating approximately $750 million and each of the senior loan and mezzanine loans contained resizing features that were utilized subsequent to the acquisition of the participation interest. Seyfarth Shaw's representation entailed negotiating the participation agreement taking into account that the other senior participation interest might be securitized, as well as negotiating an intercreditor agreement with multiple tranches of mezzanine debt.

Mezzanine Lenders continued from Page 1

lenders based on the classification of the collateral securing the obligation. The UCC generally classifies equity interests in an LLC or LP as a general intangible,[3] which can only be perfected by filing.[4] However, Article 8 of the UCC provides a mechanism, known as "opting-in," that converts the LLC and LP equity interests from a general intangible to a security,[5] which, for purposes of perfection, is characterized as investment property under Article 9.[6] Investment property may be perfected by filing, mere possession or control.[7]

To "opt-in" to Article 8 (which converts the LLC or LP equity interest from a general intangible to a security), the respective operating or partnership agreement of the LLC or LP must expressly provide that its membership or partnership interests are securities governed by Article 8 of the UCC.[8]

If the equity interest in an LLC or LP is a certificated security,[9] a mezzanine lender can take control of "investment property" (which includes a certificated or uncertificated security) by delivery with endorsement in blank.[10] If however, the equity interest in an LLC or LP is an uncertificated security,[11] a mezzanine lender can take control by an agreement from the issuer that it will comply with instructions originated by the mezzanine lender without further consent of the mezzanine borrower.[12]

Mezzanine lenders generally prefer that the securities be certificated (rather than uncertificated) because of the potential risk that the issuer may subsequently certificate the uncertificated securities and deliver them to a new mezzanine lender.[13] If the new mezzanine lender qualifies as a "protected purchaser" under Article 8, the new mezzanine lender would take its security interest free of any adverse claim made by the original mezzanine lender.[14]

Two Mezzanine Lenders taking control of the same equity interests in an LLC or LP

Assuming the LLC or LP equity interests are certificated and are in registered form, a senior mezzanine lender can perfect by control upon delivery of the certificates with an endorsement in blank.[15] The junior mezzanine lender can also perfect by control in the same certificates upon acknowledgment by the senior mezzanine lender that it holds the certificated securities and endorsement in blank for itself and on behalf of the junior mezzanine lender.[16] This can be done in an intercreditor agreement, which should also set forth each mezzanine lender's respective rights and priorities in the equity interests of the LLC or LP.

Seyfarth Shaw's national Structured & Real Estate Finance group has particular experience in originating and enforcing mezzanine loans.

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The authors would like to thank Daniel J. Evans of Seyfarth Shaw for his assistance in preparing this article.

1 See Lynn A. Soukup, *''Opting In" to Article 8 -- LLC, GP & LP Interests as Collateral,* COMMERCIAL LAW NEWSLETTER, AMERICAN BAR ASSOCIATION, SECTION OF BUSINESS LAW (July 2002). Prudent mezzanine lenders will typically perfect by control and also file a financing statement in the appropriate filing office in the jurisdiction where the debtor is located.

2 *See generally* U.C.C. §9-328.

3 See U.C.C. §9-102(a)(42).

4 U.C.C. §9-310.

5 U.C.C. §8-103(c).

6 *See* U.C.C. §9-102(a) (49).

7 U.C.C. §§9-312(a), 9-313(a), 9-314(a). Control of investment property (e.g., possession of investment property with an endorsement in blank) prevails in priority over perfection by mere possession (e.g., possession of investment property without an endorsement in blank) and perfection by filing.

8 *See* U.C.C. §8-103(c). It may be prudent for the mezzanine lender to require that the real property owner's organizational documents prohibit subsequently "opting-out" of Article 8 and that the mezzanine borrower provide an irrevocable proxy to the mezzanine lender regarding certain voting rights. See Supra note 2.

9 We assume that all certificated equity interests would be in registered form.

10 *See* U.C.C. §§9-106(a), 8-106(b).

11 We assume that all uncertificated equity interests would be in registered form.

12 *See* U.C.C. §§9-106(a), 8-106(c).

13 *See* James D. Prendergast and Keith Pearson, *How to Perfect Equity Collateral Under Article 8,* THE PRACTICAL REAL ESTATE LAWYER, November 2004.

14 *See* U.C.C. §8-303 (b).

15 *See supra note* 10.

16 *See* U.C.C. §§8-301(a)(2), 8-106(b)(1).

SREFacts

NEW ADDITIONS

Washington, D.C. A team of real estate attorneys headed by **Ronald Gart** joined the firm's Washington, D.C. office. In addition to Gart, the team includes partners **Christa Dommers** and **Adam Walsh**, and **Peter Segal** joins Seyfarth Shaw as Of Counsel. This group of attorneys had been partners at Powell Goldstein, and they bring with them three associates and a paralegal in their move to Seyfarth Shaw.

SEEN & HEARD

Structured and Real Estate Finance Practice Group (SREF) Featured in *Real Estate Finance & Investment*. SREF Co-Chairs **Peter Korda** (New York) and **Andrew Pearlstein** (Boston) were quoted in the article, "Seyfarth Shaw Targets Lenders, Workouts," published in the March 17, 2008 issue of *Real Estate Finance & Investment*.

Paul Baisier (Atlanta) was a panelist at IMN's Distressed Real Estate Investing Symposium on March 18, 2008 in Miami Beach. Paul Baisier participated in the panel titled, "Workout, Foreclosure & Bankruptcy Processes: A Practical Legal Roadmap."

The Distressed Asset Resolution Team presented a seminar to nearly 50 members of Ernst & Young's Transaction Real Estate Group on April 23, 2008. The session was designed to prepare the audience for the current real estate foreclosure and workout environment. Topics included: Securitization and the Workout; Bankruptcy Basics; Safe Harbors, Participations, Material Adverse Change Clauses and Original Issue Discounts; Tax Implications of Debt Workouts, Foreclosures and Bankruptcies; and, Mezzanine Loans. The Seyfarth team received very positive feedback from the audience. Please contact **Andrew Pearlstein** (apearlstein@seyfarth.com) for more information on this program.

Mitchell Kaplan (New York) recently conducted a firm-wide continuing legal education training seminar focusing on real estate loan workouts from the lender's perspective, including issues unique to CMBS transactions and transactions with participation interests and mezzanine tranches. Please contact **Mitch Kaplan** (mkaplan@seyfarth.com) for more information.

On April 7, 2008 lawyers from the commercial lending, bankruptcy and litigation practice groups met with over 30 loan officers from Citizens Bank in Boston to discuss current trends in lender liability claims. The group addressed how lender liability claims can arise in loan management and workouts and discussed strategies to avoid these types of claims. They also discussed the issues arising in the Clear Channel litigation and other claims based on loan commitments. Please contact **Peter Brooks** (pbrooks@seyfarth.com) for more information.

Peter Korda (New York) and Jim Cochran (Los Angeles) were panelists at IMN's 5th Annual Western Borrowers' & Investors' Forum on Real Estate Mezzanine Loans in Beverly Hills on April 14, 2008. Peter Korda moderated a panel titled "Intercreditor Agreements and Deal Negotiations: The Legal Perspective," and **Jim Cochran** was a panelist in the session titled "Distressed Loans and Bankruptcy: Working Out Defaults." More than 250 people attended the Forum, which featured a broad range of mezzanine loan experts covering a wide variety of topics. Please contact **Peter Korda** (pkorda@seyfarth.com) or **Jim Cochran** (jcochran@seyfarth.com) with any questions about the Forum.

On April 22, 2008, the Atlanta Real Estate Group and Distressed Asset Resolution Team co-hosted a breakfast briefing titled "Atlanta Real Estate 2008: Challenges & Opportunities." This program examined how the perfect storm created by the current economy is impacting the residential and commercial real estate markets in Atlanta in 2008, how recourse liability is affecting some participants, and what lessons can be learned from this downturn to better plan for the future. The program also considered what opportunities the down market has made available, how to take advantage of those opportunities, and what strategies make the most sense in the months ahead. Please contact **Mike Rodgers** (mrodgers@seyfarth.com) for more information.

UPCOMING EVENTS

Please visit our Website www.Seyfarth.com to register for any of the following programs (except where noted).

5/27/2008
Ninth Annual US Real Estate Opportunity & Private Fund Investing Forum (New York). Partners **John Napoli** and **Joel Rubin** will be presenters at this forum hosted by the Information Management Network. Napoli will be on the panel, "Legal & Tax Aspects of Project Level Real Estate Workouts, Defaults & Foreclosures" and Rubin will be speaking on the panel, "Failing Joint Ventures: What Are Your Options?"
For more information on this program please visit the event's website at www.imn.org.

6/11/2008
Commercial and Real Estate Loan Documents in Georgia: More Than Just Papers (Atlanta). **Mike Rodgers**, **Jay Wardlaw** and **Jeff Cunningham** of the Seyfarth Shaw Atlanta office will speak at this day-long seminar. The program is hosted by Lorman Education Services and will be held at the Holiday Inn Atlanta Airport North. Please visit www.lorman.com to register for this program.

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