COMMERCIAL

Are You Ready for the Next Downturn?

A Primer on Key Cases Affecting Commercial Real Estate Lenders in California

by
MICHAEL R. FARRELL,
Partner, Allen Matkins

When will the next economic downturn arrive? Prognosticators give a wide variety of opinions on that question, with some predicting many months of continued prosperity and others predicting imminent doom. The one thing they all agree on is that a down cycle is coming, and it's coming relatively soon.

When it arrives, lenders secured by California real estate will have to reacquaint themselves with loan enforcement tools they may have been able to set aside, happily, for a while. Here are some key cases decided in the last few years that may affect lenders' future loan enforcement efforts.

FORECLOSURE

A Lender May Be Able to Both Foreclose on a Senior Lien and Seek a Deficiency on a Junior Lien

Since the 1992 decision in *Simon v. Superior Court*[1], California lenders holding senior and junior liens on the same real property were barred from both non-judicially foreclosing on the property and seeking a deficiency judgment on the junior lien. The *Simon* court recognized that a true "sold-out junior," whose lien was extinguished because a third party senior lender decided to conduct a non-judicial foreclosure sale, was not barred from seeking a deficiency judgment, but held that if a party controlled both the senior and junior liens and all related foreclosure decisions, they were not a true sold-out junior and that anti-deficiency laws barred them from pursuing a deficiency judgment. The *Simon* court was concerned that if the rule were otherwise, lenders would structure a single loan as two loans to increase potential recoveries against the borrower, thereby circumventing anti-deficiency protections.

In *Black Sky Capital, LLC v. Cobb*[2], California's Fourth District Court of Appeal recently rejected the reasoning of *Simon*, and held that a lender was not necessarily barred from enforcing the junior debt under these circumstances. The *Black Sky* court narrowly interpreted the anti-deficiency language of Code of Civil Procedure § 580d and determined that it did not apply to the junior lien in that case because the senior and junior debts were separate obligations made years apart and there was no evidence the second loan was made in an attempt to circumvent the anti-deficiency statutes. Note, the California Supreme Court has granted review of this case, and an opinion may issue later this year.

...Next Downturn continued on page 56

Next Downturn continued from page 29…

Impact. The *Black Sky* decision potentially opens the door for lenders to enforce two liens on the same property in this manner for the first time in over 25 years. Lenders in the right circumstances would have option to sue the borrower for collection of the "sold-out" junior lien debt following the foreclosure of the senior lien. However, the court's analysis left open many questions concerning what circumstances might be seen as an attempt to circumvent anti-deficiency laws (e.g. what if the two loans were made simultaneously, not years apart?). The California Supreme Court's decision may provide clarity on this issue one way or another. Stay tuned.

BANKRUPTCY

"Cramdown" Value = Replacement Value (even if it's less than foreclosure value)

In *In re Sunnyslope Housing Limited Partnership*[3], the Ninth Circuit, in an *en banc* opinion, addressed how a secured creditor's interest should be valued in the context of a "cramdown," i.e. where the debtor seeks to retain and use creditor's collateral in the reorganization plan and the value of that collateral is to be determined based on the proposed use of the property. Valuation for the "cram-down" plan was critical to the case in determining how much the secured creditor would recover under the proposed plan based on the present value of the secured creditor's claim against the property. The *Sunnyslope* case presented a highly unusual circumstance where the foreclosure value of the apartment complex collateral was significantly higher than the replacement value due to the existence of low-income housing covenants that would be extinguished in a prospective foreclosure.

Despite the higher foreclosure value supported by the secured creditor, the Ninth Circuit affirmed application of the replacement value standard for determining the secured creditor's present value of its claim under the plan. In doing so, the Ninth Circuit expressly rejected the idea that a secured creditor could expect to receive the highest valuation available under these two standards. Instead, the replacement value standard would be applied in determining present value of a secured creditor's claim in property.

Impact. Lenders facing a potential "cramdown" of its secured claim, based on present value of its claim against real property, should carefully analyze the potential difference between a property's foreclosure value and its replacement value and adjust expectations accordingly.

GUARANTIES

Appellate Court Narrows the Scope of the Sham Guaranty Defense

California's anti-deficiency statutes limit a lender's right to recover a deficiency judgment against the borrower after a non-judicial foreclosure sale, but such protections generally do not extend to guarantors. A number of guarantors have successfully asserted a defense to guaranty enforcement called the "sham guaranty" defense, arguing that they should be treated as borrowers (and therefore protected from a deficiency judgment), either because they were the "true" principal obligor on the loan by reason of a legal doctrine such as alter ego or trust law, or because the lender had improperly relegated them to the guarantor role in order to circumvent anti-deficiency laws.

In *LSREF2 Clover Property 4 LLC v. Festival Retail Fund 1, L.P.*[4], California's Second District Court of Appeal continued a recent trend of limiting application of the sham guaranty defense. The court, in rejecting application of the defense, focused on the fact that there was no evidence the lender was attempting to circumvent anti-deficiency laws at the time of the loan. The lender did not structure the loan transaction or mandate the form or identity of the borrower – the borrowing parties already had a proposed structure and borrower in place when they sought the loan. Also, while the court acknowledged the existence of certain facts that might support an alter ego finding, it noted that at the time of the loan, the lender was unaware of most of those facts. In prior sham guaranty decisions, courts allowed a guarantor to establish the sham guaranty defense either by proving an alter ego relationship (i.e. there is such unity between a corporate entity and its owner(s) that it would be inequitable to recognize the separateness of the entity) or proving lender's intent to circumvent anti-deficiency law. In *LSREF2* , the court stated that a

…Next Downturn continued on page 57

Next Downturn continued from page 56...

potential alter ego relationship "is just one factor" and that if the lender was unaware of those facts, the defense would be inapplicable. Thus, guarantors attempting to establish the defense will likely have to show that the lender either mandated and controlled the loan/guaranty structure or was aware the borrowing parties failed to follow corporate formalities.

Impact: Before bringing an action against a guarantor, a lender should investigate what role it, or its predecessor, played in choosing the loan structure and the corporate form of the borrower, and should also investigate what facts were available to it at the time of the loan that might point to an alter ego relationship between the borrower and guarantor.

1 4 Cal.App.4th 63 (1992).
2 12 Cal.App.5th 887 (2017)
3 859 F.3d 637 (9th Cir. 2017)
4 3 Cal.App.5th 1067 (2016)

Have you updated your Membership Directory listing?

One of the benefits of your California MBA membership is inclusion in our online Membership Directory! Make sure your company's info is up to date! Email dustin@cmba.com for more information!

Understanding continued from page 30...

ends up paying the lower utility bills. This negates the whole foundation of the ROI driving energy savings projects.

On the flip side of this equation stands the tenant who actually pays the bills often has limited options at their disposal to save energy. It is unlikely that a tenant will be allowed to install additional insulation, change their windows, install a low flow toilet, or other potential energy and water savings improvements. Perhaps the only one they have true control over would be installing LED bulbs in their fixtures.

This is where the Fannie Mae and Freddie Mac Green programs come into play. Approximately one year ago, they created a unique solution that bridges this gap and aligns the interests of both sides. The specifics of each program differ; however, both agencies have created a fairly simple program that centers on two basic steps. First, the landlord/borrower has an energy audit performed with the costs typically covered by the Lender. This audit is generally performed as part of the standard Property Condition Assessment and is non-invasive in nature. Second, the borrower is required to implement some of the projects recommended in order to receive a percentage off of their loan rate.

Of course, there are small print details that come along with any program. Primarily, there is a minimum level of savings of either energy savings or water savings; currently set at 25% water OR energy savings. Further, there are energy baseline and ongoing reporting requirements. However, the overall intent of the program, to bring the divergent sides together, is undoubtedly met and each side gains; the owner invests money and gets a lower interest rate, while the tenants save money through lower utility bills. Of course, in the cases where a bill back is not in place, then the owner would gain from both lower interest rates and lower utility bills.

At the MBA conference in San Diego in February, many Lenders told me that the Green program option is being utilized in a very high percentage of their multi-family deals. In a time when interest rates are rising, we expect to continue to see significant interest in this program in an effort to reduce financing costs.

GRS Global is one of a handful of firms pre-approved by both Fannie Mae and Freddie Mac to perform these assessments. If you are involved in a multi-family financing project and have questions about this program, please do not hesitate to reach out to me. I'll walk you through the process, run your projects through our pre-qualification analysis, or just answer your general questions about the program.