FEATURED ARTICLE

The New Age of Real Estate Loan Defaults

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I. Introduction

When the music stopped for the global credit markets in late 2007, the value of many mortgage-related assets plummeted. The damage caused by the mortgage credit downturn of 2007 and 2008 has yet to be fully understood, but it is clear that certain mortgage lenders, investment banks, hedge funds, bond insurers, and other holders of affected assets are already suffering huge losses. The effects of the downturn extend far beyond its origins in the United States subprime residential mortgage sector. The contraction and shifting of credit availability for the purchase and refinancing of real estate has created a "credit crunch" that slows the pace of real estate activity. Securitizing mortgage lenders have been especially hard-hit as the market for bonds backed by mortgages has contracted, thus slowing the pace of mortgage origination for securitization. Poor credit decisions relating to existing commercial and residential assets and the contraction of credit availability are adversely affecting economic "fundamentals" such as employment and consumer spending, which tends to depress real estate values. After years of prosperity, it appears that we are entering a "down cycle" in real estate.

Many real estate law practitioners worked during earlier real estate downturns, representing clients hurt by the downturn and clients that profited from others' misfortunes. Today, seasoned real estate lawyers are resuming and expanding their practices in loan defaults and remedies, workouts and foreclosures, and bankruptcy, along with newer real estate lawyers who have never worked in a deteriorating real estate market environment.

Real estate lawyers will produce many articles and give many speeches in 2008 about real estate loan defaults. This article discusses several issues that arise in defaulted commercial real estate loans—notice of default, enforcement of nonrecourse carve-out guaranties, prepayment restrictions, late charges, and the finality of foreclosure—and illustrates the issues by reviewing an important recent court decision on each topic. The authors hope that this article will provide a springboard that introduces, or reintroduces, the reader to the law of real estate finance in this new age of real estate loan defaults.

II. Commencing Nonjudicial Foreclosure by Notice of Default

The filing of a notice of default under a deed of trust with power of sale is often the lender's first exercise of a default remedy after a borrower's loan default. The form and required contents of the notice of default are specified by statute. CC §§2924, 2924c. The contents of the

notice of default must comply strictly with the statutory requirements, which are intended to protect the borrower from a wrongful or unfair loss of the property. A trustee sale based on a statutorily deficient notice of default may be invalidated.

Under §2924(a)(1), the power of sale under a deed of trust "shall not be exercised" until a notice of default is recorded "identifying the ... deed of trust ... [and containing a] statement that a breach of the obligation ... has occurred ... setting forth the nature of each breach actually known to the beneficiary...." The notice of default informs the borrower of the existence and nature of the default so that the borrower has an opportunity to pay the obligation, or cure the default and reinstate the obligation. Section 2924c grants to a borrower, or any beneficiary under a subordinate deed of trust, the right to reinstate the defaulted obligation by paying all defaulted amounts and the lender's enforcement costs and expenses. After recording the notice of default, the lender must wait 3 months before publishing a notice of sale. §2924(a)(2). Reinstatement may be made until 5 business days before the foreclosure sale date stated on the recorded notice of sale. §2924c(e).

The case of *Anolik v EMC Mortgage Corp.* (2005) 8 C4th 1581, 28 CR3d 759, illustrates how lenders must take care in analyzing and handling existing defaults and preparing the notice of default, and how an attempted foreclosure based on an erroneous notice of default may be subject to attack.

Plaintiff Anolik bought a home in 1998 with a mortgage loan secured by a deed of trust in favor of defendant EMC. After Anolik's default, EMC recorded a notice of default on July 6, 2000. Anolik sued EMC, seeking to enjoin the pending foreclosure sale and a declaration that the notice of default was void. EMC prevailed at trial, but the appeals court reversed.

The events that ultimately invalidated EMC's notice of default began long before the notice of default was filed. Civil Code §2924 requires that a notice of default must set forth at least one accurate statement of a breach that is sufficiently substantial to warrant the remedy of foreclosure. The court of appeal ultimately found that EMC's notice of default failed to state even one default that existed at the time the notice was filed.

The court determined at the outset that the portion of EMC's notice of default that described a general, nonspecific default for failure to pay late charges, advances, assessments and attorneys' fees, "if any," did not state a specific breach and, therefore, failed to meet the statutory standard.

EMC's notice of default also asserted that Anolik was in default for failure to make all payments due in March, April, May, June, and July 2000. In October and December 1999, EMC had paid property tax bills that Anolik failed to pay as required before delinquency. Instead of demanding reimbursement of the tax advances as permitted under the deed of trust, EMC "forced" an impound account on Anolik starting in December 1999 and thereafter attempted to collect higher monthly payments, including additional amounts monthly to recover the tax advances and to pay future tax payments. Anolik continued making payments but never paid the increased monthly payment amount. The court found that EMC had no right under the loan documents to impose an impound account on Anolik and, therefore, Anolik could not be in default for failure to make the increased payments due in March, April, May, or June 2000.

Anolik did not make the July 2000 payment, but the court ruled that this failure was not a "sufficiently substantial breach" at the time the notice of default was filed on July 6, 2000. Thus, according to the appellate court analysis, Anolik was not in default for failure to pay any of the identified monthly installments at the time the notice of default was filed.

EMC argued further that, even if the stated defaults did not exist, Anolik was nonetheless in default when the notice was filed because Anolik had never paid the installment due in December 1998. The court rejected the argument since the notice of default did not give notice of that particular payment default. In sum, the court ultimately held that the notice of default was defective because it failed to accurately identify a default existing at the time the notice was filed.

The *Anolik* case stands as a cautionary tale for lenders and their counsel, and reminds borrowers' counsel that a lender's nonjudicial foreclosure may be attacked by seeking to invalidate the notice that commences the foreclosure process. A notice of default is often prepared under pressure to quickly commence foreclosure. Gathering and organizing the necessary information about the defaults, the accelerated loan balance, and the correct reinstatement amount can be more time-consuming and burdensome than expected. If an error in the notice is discovered later, a corrected notice may be recorded, but the 3-month waiting period and the period for reinstatement will have to start over.

III. Enforcement of Nonrecourse Carve-Out Guaranties

Nonrecourse commercial real estate loans often contain "carve-outs" to the recourse limitations providing that the borrower will be liable to the lender for "bad acts" such as fraud, misappropriation of rents, transfer or encumbrance of the collateral without the lender's consent, waste, and bankruptcy of the borrower. Some carve-outs create liability to the extent of any damage suffered by the lender as the result of the bad act. Other carve-outs will trigger full recourse liability for the entire principal balance of the loan. The lender may also require that a "warm body" guarantor execute in favor of the lender a guaranty of the borrower's nonrecourse carve-out liabilities. In securitized real estate loans, the list of bad acts includes the borrower's failure to maintain itself as

a single-purpose bankruptcy-remote entity as required in the loan documents. The nonrecourse carve-out guaranty is a critical source of credit support because the single-purpose borrower by definition has no assets other than the mortgaged collateral to support payment and performance of its loan obligations and recourse liabilities.

The case of *Blue Hills Office Park LLC v J.P. Morgan Chase Bank* (D Mass 2007) 477 F Supp 2d 366 was a "high stakes, winner-takes-all, quintessentially complex commercial case" decided by a federal district court in Massachusetts that produced the first published decision enforcing a nonrecourse carve-out guaranty of a securitized loan. In 1999, Credit Suisse First Boston Mortgage Securities Corp. made a loan to Blue Hills Office Park, LLC for $33 million that was secured by a mortgage on the borrower's Blue Hills Office Park. The borrower was a newly formed single-purpose bankruptcy-remote entity. The loan was nonrecourse subject to full recourse liability carve-outs for failure to maintain the borrower's status as a single-purpose entity, and for transfer of any part of the mortgaged property without the lender's consent. The loan also contained other limited recourse carve-outs. Two principals of the borrower guaranteed the loan under a guaranty with the same nonrecourse carve-outs found in the loan documents. The loan was securitized after closing.

At the time of loan closing, the Blue Hills Office Park was 100-percent occupied by tenant Boston Equiserv Limited Partnership, whose lease was set to expire in 5 years. Blue Hills learned that Equiserv intended to vacate the property at the end of the lease term so that it could purchase and relocate to an adjacent property. Equiserv's obligation to buy the new property was conditioned on the seller having obtained a special permit to construct a new parking garage. In an attempt to keep Equiserv as its tenant on the property, after the special permit was issued, Blue Hills appealed the issuance of the special permit on the grounds that the new garage would block sight lines and views and diminish the value of Blue Hills' property.

Shortly thereafter, however, Blue Hills settled with the owner of the adjacent property. Under the settlement, Blue Hills received a payment of $2 million and waived all further rights of appeal. The settlement assured that Equiserv would buy the adjacent property and relocate, leaving Blue Hills Office Park vacant.

Blue Hills never told its lender about the settlement, the waiver of appeal rights, or the settlement payment. The borrower's $2 million settlement payment was wired directly to a client account at Blue Hills' law firm in the name of a member of Blue Hills controlled by the guarantors. Later, the money was split between the guarantors.

After Equiserv vacated, Blue Hills defaulted on the loan. The lender foreclosed and an affiliate of the lender made the high bid and took the property at the foreclosure sale, resulting in a $10.77 million deficiency. The property was later sold to a third party. After the foreclosure sale, the lender learned about the settlement payment from a real estate broker.

In early 2005, the borrower filed a lender liability claim against the lender, and the lender counterclaimed against Blue Hills and the guarantors for full recourse liability for the deficiency. The court rejected all of the borrower's claims against the lender. On its counterclaims, the lender asserted that the borrower and guarantors were liable for the deficiency because of the borrower's bad acts:

- The transfer of the settlement payment and the waiver of the zoning appeal rights; and
- The failure to maintain the borrower's status as a single-purpose entity.

The borrower argued that the restrictions on transfer of the mortgaged property referred only to transfers of the real estate. The court decided that the language of the loan documents suggested the opposite, and the $2 million settlement and the borrower's rights to the zoning appeal constituted a part of the mortgaged property. The court reasoned that, in a nonrecourse loan, the lender looks entirely to the mortgaged property for security; to protect only the real property would be unreasonable and impractical. 477 F Supp 2d at 378. The court held that the transfer of the payment and waiver of the appeal rights without the lender's consent violated the restrictions against transfers of the mortgaged property, and the guarantors were liable for the full amount of the deficiency. 477 F Supp 2d at 382.

The court further determined that the borrower failed to maintain its status as a single-purpose entity by

- Commingling the $2 million settlement with the funds of another entity; and
- Violating its obligation to maintain an independent director that participated in the borrower's affairs as required under the loan documents.

The court said that it was not persuaded that the borrower and guarantors intended to defraud the lender. Instead, the borrower conducted its business under the erroneous impression that the settlement was not part of the mortgaged property. The borrower and the guarantors had been counseled by their attorneys throughout the events that resulted in the settlement of the zoning appeal and transfer of the $2 million settlement. The court suggested that the guarantors either received bad advice or failed to heed their attorneys' warnings. Without judging what happened between attorney and client, the court expressed its

> regret over the time, money, and resources that necessarily have been expended to correct this faulty settlement structure. Lawyers must remember that, in the very essence, they are their client's teachers – teachers of the law and how the law is most likely to be applied to the evidence available.... Here one is left with the indelible impression that positions were taken and structures arranged with a view to salvaging something from a gen-

eral wreck that would inevitably be "worked out" rather than scrutinized by the full processes of careful trial and adjudication.

477 F Supp 2d at 384.

IV. Restrictions on Real Estate Loan Prepayment

Under common law rules, a lender is not obligated to accept prepayment of a note unless the note is prepayable by its terms. Real estate loan documents customarily address the circumstances under which a borrower may prepay a loan. Prepayment restrictions vary. Commonly, prepayment is prohibited altogether during an initial period, followed by a period during which the loan may be prepaid together with a prepayment premium, with a short open prepayment period during the several months prior to maturity. A prepayment premium may be expressed simply as a percentage of the amount being prepaid. More likely, the note will provide a "yield maintenance" formula that attempts to compensate the lender for the loss of interest income as the result of early payment.

A typical yield maintenance formula provides for payment of the greater of

- A fixed percentage (such as one percent) of the principal balance being paid; or
- An amount equal to the difference between
  - The remaining principal and interest payments on the loan (including any balloon payment at maturity), discounted to present value based on an index derived from U.S. Treasury obligations; and
  - The amount of principal being prepaid.

To the extent the index for discounting to present value is lower than the note rate, the yield maintenance formula will produce a higher amount due. Yield maintenance formulas that apply an index based on a U.S. Treasury obligation (a so-called "Treasury-flat" formula) are often criticized because the index, which is almost always less than the note rate, may inflate the yield maintenance premium.

Under California law, prepayment premiums are treated as an alternative performance under the contract rather than as liquidated damages; however, an excessive prepayment premium may be unenforceable. See *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1972) 22 CA3d 303, 99 CR 417.

The case of *River East Plaza, LLC v Variable Annuity Life Co.* (ND Ill 2006) 2006 WL 2787483 captured the attention of many lenders and their counsel after the Illinois district court disallowed the imposition of a Treasury-flat prepayment penalty against a commercial borrower.

In 1999, River East Plaza, LLC, borrowed $12.7 million from Variable Annuity Life Insurance Company at a fixed rate for 20 years, secured by a mortgage on the borrower's commercial property. On prepayment, the promissory note provided for payment of a prepayment premium equal to the greater of (i) one percent of the principal prepaid or (ii) the difference between the discounted present value of the remaining principal and interest payments and the principal prepaid. Approximately 3 years later, the borrower elected to pay off the loan so that it could sell the property to the tenant. When the borrower requested a pay-off amount from the lender, the lender calculated the prepayment fee at $4,713,000, which was around 38 percent of the principal balance. (The amount of the fee was later reduced to approximately $3.9 million to correct a calculation error.) After the lender denied the borrower's request for a waiver of the prepayment fee, the borrower paid the loan in full, including a payment of the prepayment premium under protest, and sued the lender to recover what the borrower characterized as an unreasonable prepayment penalty.

In the Illinois district court, the borrower argued that the prepayment provision should be analyzed as a liquidated damages clause. The lender argued that the clause was a contractual, bargained-for form of alternative performance. In its decision, the district court applied a liquidated damages analysis to determine the "reasonableness" of the prepayment fee. The court resolved to uphold the prepayment premium only if it appeared to be a reasonable, agreed-upon estimate of the lender's potential damages from prepayment, *calculated at the time of contracting*, under circumstances where actual damages would have been difficult to fix. The court held that the prepayment premium was not reasonable at the time of contracting because it did not bear any relationship to the actual damages sustained by the lender as a result of prepayment. The court said that a reasonable prepayment premium instead would equal the present value of the interest unpaid due to early principal payment, assuming the lender invested the prepaid principal in an investment comparable to the prepaid loans, and not a present value calculated based on the Treasury-flat formula. The court invalidated the yield maintenance amount as a penalty but allowed the lender to recover the alternative one-percent fee.

In the lender's appeal to the Seventh Circuit Court of Appeals, *River East Plaza, LLC v Variable Annuity Life Co.* (7th Cir 2007) 498 F3d 718, the court began from the position that Illinois courts will not enforce penalty clauses. If the sole purpose of the clause is to secure performance, then the clause is a penalty. To distinguish between a penalty and a permissible contractual alternative form of performance, it is necessary to evaluate the relative values of the alternatives presented to the borrower under the circumstances. The court reasoned that River East would have paid an additional $13 million in interest through maturity, but instead paid $3.9 million for the privilege of prepayment. By that analysis, the fee hardly appeared to be a penalty. The borrower had bargained for the right to prepay and, on exercise of that right and payment of the premium, was released from a larger

long-term payment obligation. In overturning the district court decision, the court emphasized that "a contrary result would have broad implications for both lenders and borrowers of mortgage-secured loans ... and might inadvertently effect a wide-ranging alteration of the law of real estate financing." 498 F3d at 725.

V. Enforcement of Late Fees

Almost all institutional promissory notes contain a clause permitting the lender to collect a late charge if payment under the note is not made when due. Since the California Supreme Court decision in *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 CA3d 731, 108 CR 845 (*Garrett*), late charges must comply with liquidated damages requirements. Civil Code §1671 now provides that a liquidated damages provision such as a late charge is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made. CC §1671(b).

The recent court of appeal case, *Poseidon Dev., Inc. v Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 62 CR3d 59, reported in 30 CEB RPLR 154 (Sept. 2007) (see also Bernhardt, *Later Thoughts on Late Charges*, 30 CEB RPLR 140 (Sept. 2007)), illustrates one appellate court's reaction to a lender's attempt to collect a large late fee on a late balloon payment.

In 2004, plaintiff Poseidon Development made a one-year, interest-only loan to Woodland Lane Estates, LLC, for $770,000. The promissory note provided that, if an "installment" was not paid when due, the borrower would pay the lender a late charge equal to 10 percent of the overdue amount to compensate the lender for the administrative expense incurred due to the late payment. Woodland paid all of its interest installments on time, but failed to pay the $770,000 balloon payment at maturity. After Poseidon commenced foreclosure proceedings, Woodland eventually paid the loan but refused to pay a late charge of $77,000.

Poseidon brought a breach of contract action against Woodland seeking damages and recovery of the $77,000 late charge for the missed balloon payment. Poseidon argued that the balloon payment constituted an "installment" subject to late charge if not paid when due. The trial court disagreed. The court of appeal reversed the trial court decision on procedural grounds; however, the court of appeal also held that Poseidon was not entitled to collect the late charge on the balloon payment.

First, although the loan documents used the words "installment" and "payment" interchangeably, the language of the note suggested that the final payment on maturity was not an installment to which the late charge should apply. Second, if the late charge provision were to apply to the balloon payment, then the late charge would be considered unreasonable liquidated damages because the damages bore no relationship to the actual damages contemplated at the time the loan was made. The late charge was intended to compensate Poseidon for administrative expenses, and the parties could not have reasonably contemplated at the time the loan was made that Poseidon would suffer $77,000 in administrative expense if the balloon payment were not paid on time.

The *Poseidon* case suggests that more careful drafting of the note and late charge provision could have clarified an intent to apply the late charge to the balloon payment. However, it is not clear that more attention to detail could save a late charge under a liquidated damages analysis if calculated as a percentage of the entire principal balance. See *Garrett, supra*. The better practice may be to apply the late charge to regular installment payments and attempt to collect default interest on the past due balloon payment until paid, although it is not clear whether default interest charged on the entire principal balance could survive scrutiny under CC §1671(b) and the *Garrett* case.

VI. Finality of Judicial Foreclosure Sale

A recent case illustrates how combining a traffic jam with the strict rules on the finality of judicial foreclosure sales can have disastrous results for the lender. In *Amalgamated Bank v Superior Court* (2007) 149 CA4th 1003, 57 CR3d 686, reported in 30 CEB RPLR 161 (Sept. 2007), the lender, as cotrustee for Pension Trust Fund for Operating Engineers (PTF), held a security interest in property owned by the borrower, Winncrest Homes (Winncrest), to secure a loan by PTF to Winncrest. When Winncrest ceased making payments on the loan, PTF brought a judicial foreclosure action against Winncrest and obtained a judgment allowing the property to be sold at a sheriff's sale subject to right of redemption.

The sale was set to begin in Sacramento at 10:00 a.m. on the appointed day. A third party bidder named Bruce Palmbaum arrived to bid on the property with ample available funds. The property was worth around $6.5 million, and Palmbaum intended to make a $6 million opening bid. The sheriff commenced the sale at 10:00 a.m., and Palmbaum made a $2000 opening bid. No other bidders were present, not even the beneficiary, because PTF's designated bidders had gotten stuck in traffic on the way from the Bay Area to the sale in Sacramento, arriving after 10:00 a.m. When the sheriff confirmed the sale to Palmbaum for $2000, PTF objected, but the officer stated that the sale was closed; PTF's collateral was gone.

PTF filed an action to set aside the foreclosure sale, cancel the sheriff's deed, and restrain Palmbaum from disposing of the property. It was in that context that the court reviewed whether the foreclosure sale should be set aside.

Under CCP §701.680, a sheriff's sale in judicial foreclosure is "absolute" and "may not be set aside for any reason" except for irregularities when the purchaser is the judgment creditor and the judgment creditor brings the motion to set aside within 90 days of the sale. In this case, the property was sold to a third party; therefore, PTF had

no right under §701.680 to set aside the sale for irregularity. The court concluded that "[t]here is simply no room in the statutory scheme for a judgment creditor (for whose benefit the foreclosure sale was held in the first place) to deprive a third party purchaser at a judicial foreclosure sale of his interest in the property by bringing an action to set aside the sale." 149 CA4th at 1018. The court apparently gave no consideration to the fact that the property had sold for a nominal price well below the actual value of the property.

VII. Conclusion

The current downturn in real estate will provide real estate lawyers with new and varied opportunities to counsel clients on how to manage problems and pursue opportunities in an uncertain real estate market. The cases reviewed in this article illustrate how several important issues of real estate finance law arise and may be resolved in the context of a distressed real estate investment.