BINGHAM

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A Year of Changes: Looking Back and Looking Forward

By Kenneth G. Lore and Barry P. Rosenthal

It is no secret that the economic crisis of 2009 dramatically impacted the real estate industry as well as a number of other industries. Described by some as "the perfect storm," rising vacancy rates and 30–40 percent declines in commercial real estate values, coupled with frozen credit markets, led to a rise in defaults, restructurings and distressed real estate opportunities, albeit not the large spike in foreclosures some market commentators initially predicted. As we began 2010, some wondered if the proverbial "other shoe" was still waiting to drop for commercial real estate, while others were cautiously optimistic about this year.

This past year changed the real estate world in ways that were previously thought to be unimaginable. Through it all, our lawyers and clients were there together, navigating the changing landscape. One of the most significant events last year was the bankruptcy filing by General Growth Properties (GGP) and 50 of its entities, which previously were thought to be bankruptcy-remote. The filing left many lenders and life companies shaking their heads, wondering how the bankruptcy filing was possible. Our team of real estate and financial restructuring lawyers has played a significant role in the matter, advising several clients, including some of the largest real estate lenders in the country, on specific issues and restructuring strategies for individual loans and loan portfolios involving various GGP-affiliated entities. We also advised banks, life companies and other lenders with respect to the workout and restructuring of real estate loan portfolios valued in the billions, with properties throughout the U.S., and handled numerous loan modifications, amendments and extensions. Coupled with foreclosures, receiverships and loan enforcement-related litigation, our real estate finance and restructuring lawyers had a busy 2009.

On the other hand, transactional real estate work in 2009 could be described, at least when compared to prior years, as minimal. Nonetheless, a number of private equity and real estate funds were able to acquire properties opportunistically as a result of the market conditions. These included one-off opportunities arising from recapitalization of dysfunctional partnerships and, surprisingly, insolvent lenders. Multifamily was the strongest asset class, and we represented clients in some of the largest multifamily purchases of the year, taking advantage of motivated sellers and available financing through Freddie Mac, Fannie Mae and state agencies.

With between $1 and $3 trillion in commercial debt set to mature between now and 2013, and

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Environmental Risks to Foreclosing Lenders

By Robert E. McDonnell, Robert N. Steinwurtzel and William J. Squires, III

Lenders should consider environmental liability risks and protections under the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") before taking a security interest in or foreclosing on real property. CERCLA provides for strict, joint and several liability for parties potentially responsible for a release of hazardous substances. Potentially Responsible Parties ("PRPs") include: current owners and operators; past owners and operators at the time of disposal of any hazardous substances; any person who arranged for the disposal, treatment or transport of a hazardous substance; and transporters of hazardous substances. PRPs are liable for all costs of remediation, response actions, natural resource damages and certain other costs incurred as a result of the release of hazardous substances. CERCLA, however, provides liability protections for lenders before and after foreclosing on real property, provided certain criteria are met. Real estate lenders should carefully evaluate steps that may be necessary to satisfy these criteria before taking a security interest in or foreclosing on their collateral.

LENDER LIABILITY PRIOR TO FORECLOSURE

CERCLA exempts *qualified* lenders from the statutory definition of "owner or operator." In order to qualify for this liability exemption prior to foreclosure, a lender must not "participate in the management" of a facility and must hold "indicia of ownership" primarily to protect its security interest in the facility or real property.

Each case is fact-specific, but the term "participate in management" means actually participating in the management or operational affairs of a facility. It does not include merely having the capacity to influence, or the unexercised right to control the facility. A lender participates in management if, while the borrower is still in possession of the facility or real property encumbered by the security interest, the lender: (1) exercises decision-making control over the environmental compliance of the facility; or (2) exercises control at a level comparable to that of a manager of the facility, such that the person has assumed or manifested responsibility (a) for the overall management of the facility encompassing day-to-day decision making with respect to environmental compliance, or (b) over all or substantially all of the operational functions (as distinguished from financial or administrative functions) of the facility other than the function of environmental compliance.

CERCLA lists several actions commonly taken by lenders that do not constitute participation in management, including, among others, the following:

- Holding, abandoning or releasing a mortgage or other security interest
- Including covenants, warranties or other terms and conditions in loan documents that relate to environmental compliance
- Monitoring or enforcing the terms and conditions of loan documents
- Monitoring or inspecting a facility
- Requiring a borrower to conduct remediation or other response actions at a facility
- Amending terms and conditions of loan documents or exercising forbearance

LENDER LIABILITY AND FORECLOSURE

A lender may foreclose on collateral without becoming subject to CERCLA liability provided that the lender did not participate in the management of the facility prior to foreclosure, and after foreclosure, seeks to sell, re-lease (in the case of a lease finance transaction) or otherwise divest the facility "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements." Thus, after foreclosure, the lender may: sell, re-lease or liquidate the facility; maintain business activities; wind up operations; undertake certain response actions; or take any other measure to preserve, protect or prepare the facility for sale or disposition without being subject to CERCLA liability as an owner or operator.

At a minimum, before foreclosing, a lender should first review the loan file to determine what environmental due diligence the borrower conducted at the time the borrower acquired the property. Although not specifically directed at lenders, lenders may seek to obtain additional protection from CERCLA liability under the "innocent landowner" or "*bona fide* prospective purchaser" exceptions, by making "all appropriate inquiries" before foreclosing. In order to satisfy the all appropriate inquiries rule, the lender should engage a qualified environmental consultant to perform a Phase I Environmental Site Assessment in accordance with

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Bad Boy Guarantees; Court Decisions Are Bad News for Guarantors

By Daniel W. Hardwick

Real estate professionals have long speculated as to whether and how so-called "bad boy" guarantees given in commercial real estate loans would be enforced by the courts. While recent cases reflect a trend upholding the enforceability of these guarantees generally, the *Princeton Park* decision issued by a New Jersey appellate court on August 11, 2009, warrants particular attention from prospective guarantors and their counsel. In that case, the guarantors were held to have full, recourse liability for the underlying loan, even though the "bad boy" act that had triggered liability under the guaranty had been cured, without any harm to the lender or the real estate, and had no bearing on the ultimate failure of the borrower to repay the debt.

The facts in *Princeton Park* are fairly typical of other commercial real estate loan transactions. In 2003, Credit Suisse First Boston Mortgage Capital, LLC made a $13.3 million mortgage loan to SB Rental I, LLC. The loan was secured by a mortgage encumbering real property and a payment guaranty executed by SB Rental's three principals. The loan was a non-recourse loan, but the promissory note and payment guaranty provided that the borrower and guarantors, respectively, would become fully liable for the debt if the borrower failed to obtain the lender's prior written consent to "any subordinate financing or other voluntary lien encumbering the mortgaged property."

Notwithstanding these recourse provisions, in May 2004, without obtaining the consent of Credit Suisse, SB Rental obtained a $400,000 loan from L.G. Financial Consultants Inc., which it secured by granting a second mortgage on the property. Although the $400,000 loan was paid off within seven months, L.G. Financial neglected to release the second mortgage from the land records. In May 2006, with the property failing and SB Rental no longer making monthly mortgage payments, Credit Suisse foreclosed on the property. Credit Suisse subsequently filed suit against the guarantors under the payment guaranty for an approximately $5 million deficiency—the balance of the loan due after applying the proceeds from the foreclosure sale—arguing that the mortgage loan had become fully recourse to the guarantors when the subordinate financing was obtained without Credit Suisse's consent.

The guarantors argued that since Credit Suisse was not harmed directly by the subordinate financing, and since the subordinate financing had no bearing on the $5 million deficiency, enforcement of the non-recourse carve-out clause held no reasonable relation to any harm suffered by Credit Suisse and, therefore, enforcement would be an unenforceable penalty against the guarantors. The lower court rejected this argument, holding that the damages sought by Credit Suisse were neither speculative nor estimated and therefore the bad boy clause was not a liquidated damages clause resulting in an unenforceable penalty. The lower court further held that the damages sought by Credit Suisse were actual and fair and that the guarantors had received the benefit of the bargain by the borrower's retention of the loan proceeds.

The appellate court affirmed the lower court decision. In particular, the court stated that "[n]on-recourse carve-out clauses like the one here are not considered liquidated damages provisions because they operate principally to define the terms and conditions of personal liability, and not to affix probable damages." The court also noted that "[b]y further encumbering the property, even if only temporarily, the defendants' actions had the potential to affect the viability and value of the collateral that secured the original loan."

In addition to *Princeton Park*, several court cases in the last decade, such as *Heller Financial v. Lee (2003)* and *Nippon Credit Bank Ltd. v. 1333 (2001)*, reflect a trend that bad boy carve-out provisions and bad boy guarantees are enforceable as written. In another notable recent case, *Blue Hills Office Park v. J.P. Morgan Chase Bank (2007)*, the United States District Court for Massachusetts held guarantors liable for a $10 million deficiency, even though the lender acknowledged that the bad boy act triggering liability under the guaranty caused no more than $2 million of damages to the lender.

With the increasing number of failed loans in today's economy, we are likely to see more lenders enforcing bad boy guarantees whenever possible. An important lesson from *Princeton Park, Blue Hills* and other recent cases is that bad boy guarantees are likely to be interpreted literally, without analyzing whether the effect of the remedies reflect the actual damages suffered by the lender. Taking this into account, guarantors should pay particular attention to the scope of their guarantees. Guarantors faced with language similar the payment guaranty in *Princeton Park* may try to limit their liability to losses or damages actually suffered by

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What Real Estate Lenders and Borrowers Need to Know About Chapter 11 Reorganization Plans and Cramdowns

By Henry S. Healy and Steven Wilamowsky

In our last newsletter, we discussed the provisions of the Bankruptcy Code applicable to entities that are formed for the purpose of holding title to a single building or project and the unique obstacles placed in the path of a "single asset" entity when it seeks relief under Chapter 11. In this issue we consider what happens later in the reorganization process, when the initial obstacles have been overcome and the entity seeks to have a plan of reorganization approved by its creditors and the court.

THE CHAPTER 11 PROCEEDING

Unlike Chapter 7 liquidation proceedings, a Chapter 11 reorganization is not usually administered by a court-appointed trustee. Control of the debtor's business ordinarily remains with the debtor, and it continues to manage its affairs subject to court supervision as the debtor in possession. While creditors have the right to request that a trustee be appointed, the court will usually leave the debtor in charge in the absence of fraud or other egregious conduct.

After the filing of early motions and responses, usually concerning operational matters, the debtor's first priority is the development of a plan of reorganization. Unless a single asset debtor files a plan having a reasonable possibility of being confirmed by the court within 90 days of commencement of the Chapter 11 proceeding, the court may lift the automatic stay of foreclosure that is imposed as a result of the commencement of the proceedings. The only way the debtor can avoid having the automatic stay lifted at the end of the 90-day period is to begin paying interest to its mortgage lender at the non-default contract rate on the value of the mortgage lender's interest in its real estate collateral. While the 90-day period may be extended by the court for cause by an order entered within the 90-day period, and other interim filing deadlines may also be extended, the 1995 amendments to the Bankruptcy Code established an 18-month outside date beyond which extensions may not be granted. Because the 90-day period may be extended by the court, and because the value of the mortgage lender's interest in its real estate collateral may be a litigable question, the protections given to creditors by these single asset provisions could be largely illusory. The debtor has the exclusive right to file a plan within the first 120 days after the commencement of a proceeding. This also may be extended, but is subject to the same 18-month firm outside date.

DEVELOPMENT, ACCEPTANCE AND CONFIRMATION OF A PLAN; CRAMDOWN PROVISIONS

In the process of development of the Chapter 11 plan, creditors are divided into various classes in accordance with the terms of their obligations and whether or not the obligations are secured. Secured creditors who are "under water" (holding collateral having a value less than the outstanding balance of the amounts secured) will have their obligations divided into two classes — a secured obligation in an amount equal to the value of the collateral and an unsecured obligation equal to the remaining balance. Undersecured creditors have both claims even if their obligations are nonrecourse. Undersecured creditors also have the right to elect to give up their unsecured claims and have their entire claim treated as secured. This election enables a nonrecourse creditor whose claim is under water in a depressed real estate market to avoid being paid off at the current value of its collateral.

Once the debtor has developed a plan, a disclosure statement concerning the plan must be filed with and approved by the court and the plan must be approved by impaired creditors and must also be confirmed by the court. A class of creditors is deemed to be impaired if the terms of the debtor obligations held by the class of creditors are modified in any way under the terms of the plan. If the plan provides that a class of debtors will be paid in full in accordance with the original terms of the obligations held by the class that class is not impaired. Within each class of creditors unanimity is not required for the class to be deemed to have approved the plan. If more than 50 percent of voting creditors holding at least two-thirds of the aggregate amount of voted claims in that class vote in favor of a particular plan, that class has accepted the plan, and other creditors in that class will be bound by the acceptance. Thus, if requisite majorities are achieved within each creditor class and the plan is otherwise confirmable, the plan will be confirmed and each creditor will be bound by its terms.

There is a second feature of the Bankruptcy Code that is employed to bind dissenting creditors. This is what is colloquially known as a cramdown. If certain requirements are met, this permits a debtor to confirm a plan even if one or more impaired classes of creditors rejects the plan. In general, a plan may be confirmed over the objections of one

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Creditor's Rights Coverage in Title Insurance; Requiem for an Endorsement

By Teresa Cella and Laura Muller

Over the past two years, title insurance companies have become increasingly more reluctant to issue creditor's rights coverage in connection with owner's and lender's title insurance policies. Owners and lenders requesting such coverage have been met with resistance from the same title insurance companies that previously issued such coverage without much push back. In early February, the Board of Governors of the American Land Title Association voted to withdraw the creditor's rights endorsement (ALTA 21). This means that title insurers will no longer offer creditor's rights coverage. In addition, Fannie Mae and Freddie Mac have announced that they have withdrawn their requirement for creditor's rights coverage. Given the unavailability of the endorsement, it is inevitable that most commercial real estate lenders will follow suit. Note, however, that this is limited to the immediate insured transaction. The 2006 version of the ALTA title insurance policy for both owners and lenders provides creditor's rights coverage for "back title" transactions, existing prior to the transaction creating the interest of the insured, and this has not changed.

WHY DID LENDERS AND PROPERTY OWNERS WANT CREDITOR'S RIGHTS COVERAGE?

To understand the background to the issues surrounding creditor's rights coverage, it is important to understand the risks that such coverage attempted to mitigate. As most of these risks find their roots in bankruptcy law, a basic understanding of the bankruptcy law principles at play is critical. Three primary bankruptcy principles that arise in the context of creditor's rights are fraudulent transfers and conveyances, preferential transfers, and the doctrine of equitable subordination, each of which is discussed below.

Simply put, a fraudulent transfer or conveyance is one where a transferor "hides" its assets from bankruptcy. A fraudulent transfer may be either intentional or constructive. In the case of an intentional fraudulent transfer, a transferor intends to "hinder or defraud a creditor" by distributing assets prior to filing for bankruptcy, whereas a constructive fraudulent transfer is a transfer for which the transferor does not receive "reasonably equivalent value" for the property transferred. A preferential transfer is a transfer that occurs prior to a transferor filing for bankruptcy that "prefers" one creditor over another by giving that creditor more assets than it would have received through the bankruptcy proceedings.

In the case of both a fraudulent transfer and conveyance or a preferential transfer, the remedy under bankruptcy law is that the property or value of the property transferred is taken from the transferee and returned to the transferor's estate. As transferee pursuant to a fraudulent or preferential transfer, the transferee finds itself in the position of a creditor, competing with other creditors to receive its payment from a bankrupt transferor. Any mortgage that had been secured by the transferred property is invalidated and the lender is left with an unsecured claim against a bankrupt borrower, unexpectedly competing with other unsecured creditors for recovery of its claim.

Under the doctrine of equitable subordination, a bankruptcy court can rearrange the priority of creditors, which could result in a lender losing the priority of its mortgage. This is ordinarily done only where the creditor is an "insider" or where the creditor is found to have engaged in wrongful conduct. Because equitable subordination usually involves wrongful action of the insured, it was not ordinarily considered to be a covered risk, even where a creditor's rights endorsement was issued.

The possibility of having a transaction voided entirely, in the case of a fraudulent transfer or a preferential transfer, is a bad result from the standpoint of property owners and lenders. Given the severity of the remedy, it is easy to see why a lender or property owner would seek insurance coverage from a title insurance company.

WHAT COVERAGE WAS PROVIDED?

The purpose of creditor's rights coverage was to shift the risk of a fraudulent transfer or preferential transfer to the title insurance company. There has been significant debate over the availability of creditor's rights coverage under the 1970, 1992 and 2006 versions of the standard ALTA title insurance policy. It is relatively safe to say, however, that with the exception of the limited "back title" coverage provided in the 2006 version of the ALTA policy (insuring against creditor's rights risks arising out of prior transactions), the standard forms of ALTA title insurance policies exclude creditor's rights claims, leaving lenders and property owners open to the risk that they will have no coverage if the insured title to the property or the validity, enforceability or priority of the lien of

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Are "Hell or High Water" Clauses Watertight? Second Circuit Permits Tenant to Terminate Commercial Lease for Construction Defects Despite Hell or High Water Provisions

By Aaron P. MacQueen

Commercial landlords and their mortgage lenders have long relied on lease clauses containing the independent covenant to pay rent unconditionally and without any abatement, reduction, diminution or offset, meaning that rent shall be paid "come hell or high water." While such clauses are generally enforceable in commercial leases, a recent Second Circuit case caused a stir in the commercial leasing industry, appearing to call into question the validity of such hell or high water provisions in the face of a defense claiming constructive eviction.

In *ReliaStar Life Ins. Co. of New York v. Home Depot U.S.A., Inc.*, the Court of Appeals for the Second Circuit held, among other things, that neither the relevant hell or high water clause nor the delivery of a "clean" estoppel certificate to a mortgage lender barred the tenant from asserting constructive eviction as grounds for avoiding its obligation to pay rent.

In *ReliaStar*, Home Depot entered into a lease with a landlord, G&S Investors, who agreed to provide a suitable building pad for Home Depot's construction of a store. Several years after Home Depot opened its store, G&S mortgaged the property to ReliaStar's predecessor in interest, and assigned to the mortgage lender all rents, income, rights, leases and profits due under any lease including the Home Depot lease. The assignment agreement further provided that Home Depot would recognize the assignment and make payments directly to the mortgagee.

As is typical with such loan assignments, Home Depot was required to execute a recognition agreement acknowledging the assignment of the lease. This document contained both an estoppel certificate stating that Home Depot did not claim any landlord defaults and a hell or high water clause that provided in pertinent part:

> Tenant understands that a substantial inducement for Mortgagee to purchase the Notes is the continuing existence of the Lease, the income stream payable there from and the direct payment to the Mortgagee of all rents and other payments due under the Lease and that in furtherance thereof the Mortgagor has by the Assignment assigned its interest in the Lease, the rents and all other payments due under the Lease to Mortgagee as security for repayment of the Note. Tenant agrees that notwithstanding anything in the Lease or this Agreement contained to the contrary, until Mortgagee notify [sic] tenant that the Assignment has been released, Tenant shall be unconditionally and absolutely obligated to pay to Mortgagee in accordance with the Assignment all rents, purchases payments and other payment of whatever kind described in the Lease *without any reduction, set off abatement or diminution whatever.* (emphasis added)

A few years later, Home Depot alleged that its store walls began to crack and that the store building began to settle unevenly as a result of a defective building pad. Landlord G&S refused to make repairs and Home Depot made its own temporary repairs, spending about $750,000; however, the uneven settling continued and Home Depot ultimately vacated the premises on the advice of its structural engineers. Home Depot stopped paying rent and notified the landlord that the building pad failure caused a constructive eviction from the premises.

When ReliaStar sued Home Depot seeking all amounts owed under the lease assignment and recognition agreement, the district court granted summary judgment against Home Depot, concluding that the recognition agreement's hell or high water clause was unambiguous and enforceable, and that therefore Home Depot was estopped from asserting any defenses to its clear obligations.

On appeal, the Court of Appeals reversed the district court's judgment and remanded the matter to have the trial court adjudicate the merits of Home Depot's constructive eviction claim, reasoning that if Home Depot was indeed constructively evicted, it follows that the lease was terminated and Home Depot was thereby relieved of its rental obligations. While noting that under the New York Uniform Commercial Code, if applicable, ReliaStar, as a good faith, for value assignee, would normally take free of ordinary defenses, the court explained that constructive eviction is analogous to the more extraordinary defenses of fraud or duress, because "it goes to the very existence of the agreement, rather than a failure to perform in accordance with the terms of the agreement." Further, the court held that the estoppel certificate did no

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CREDITOR'S RIGHTS COVERAGE, *CONTINUED FROM PAGE 5*

the insured mortgage are challenged post-policy in bankruptcy court.

Lenders and property owners, therefore, usually requested creditor's rights coverage in the form of either an endorsement to the standard form of title insurance policy deleting the creditor's rights exception or, in a few cases, with affirmative coverage against specific risks. The latter type of coverage is far more rare and is evaluated on a case-by-case basis.

Title insurance underwriters had become reluctant to issue this coverage primarily because title companies are not always in the best position to determine the possibility and extent of creditor's rights risks in any given transaction. As described above, bankruptcy law permits a court to "reach back" to invalidate a transaction that occurred prior to the bankruptcy filing. As a result, title insurance companies that had considered issuing creditor's rights coverage in connection with such transactions risked finding themselves defending a creditor's rights claim in bankruptcy court, a costly and time-consuming endeavor that is outside the normal range of title issues.

The level of diligence that a title company required depended on the type of transaction involved. Certain transactions are more likely than others to present a creditor's rights risk; thus the availability and ease of obtaining a creditor's rights endorsement varied based on the specific transaction. A simple purchase and sale of property between unrelated parties will present a significantly smaller creditor's rights risk than a multi-state transaction or a leveraged buyout or other similar type of transaction where the property securing the transfer of funds does not belong to the party that will benefit from receiving the funds.

Regardless of the transaction involved, in order to issue a creditor's rights endorsement, a title insurance company typically required a substantial amount of underwriting. Although there was no standard diligence checklist that title insurance companies employed to evaluate creditor's rights risk, title insurance companies typically required owners or lenders to provide, at a minimum, the following types of information: the organizational structure of the borrower and its relationship to other parties in the transaction; the structure of the transaction and the type of financing involved (i.e., will the mortgage be cross-collateralized); the loan-to-value ratio of the transaction (and whether or not an appraisal has been completed); the type of obligation the mortgage will secure; and the recipient of the loan proceeds. In complex transactions, the due diligence process was even more extensive and often included, among other things, a review by the title insurance company of audited financial statements and appraisals, operating statements of the property, and the creditworthiness of the borrower. In the absence of creditor's rights coverage, real estate lenders will continue to look directly to the borrowers for the types of due diligence materials required to evaluate the bankruptcy risks of any given transaction.

SUMMARY

In the current economic climate, it is easy to see on the one hand why lenders and property owners were so insistent that creditor's rights coverage be made available and on the other why title insurance companies would resist issuing such coverage. Nevertheless, the issues involved are primarily related to bankruptcy and insolvency law and valuation of property rather than title issues that can be resolved through the analysis of recorded title documents and the application of traditional principles of real estate law. Under the circumstances it is not surprising that title insurers have finally decided to bite the bullet and drop this type of coverage. It is not a stretch, however, to guess that lenders will still require some level of comfort in mitigating the bankruptcy risks that had been covered by creditor's rights endorsements and any such lender requirements likely will fall squarely at the feet of borrowers. <

ENVIRONMENTAL RISKS, *CONTINUED FROM PAGE 2*

ASTM International Standard E1527-05 (which is the industry standard deemed by the U.S. Environmental Protection Agency ["EPA"] to satisfy the all appropriate inquiries rule).

If, after foreclosure, a CERCLA action were brought against a lender, the lender bears the burden of establishing that it qualifies for liability protection. The analysis can be intensely factual. Consequently, a lender should carefully document its efforts to market or sell the real property. In addition, a lender should avoid expanding the operation of an ongoing business or taking other actions that suggest the lender intends to hold title to the property as an owner. EPA guidance uses a bright line test stating that a foreclosing lender qualifies for liability protection if it lists the facility or real property for sale within 12 months of foreclosure. Satisfying this "bright line" test, however, is not a condition precedent to obtaining the benefit of the exemption. But it is the simplest and most cost-effective method of ensuring the applicability of the liability protection after foreclosure.

At the time of foreclosure, lenders frequently arrange for an affiliated entity—such as a newly formed subsidiary or special purpose entity—to take title to the real property. In many cases, the lender entity will continue to hold the security instrument when the affiliated entity takes title. While there may be title, liability protection or other important reasons for this arrangement, the affiliated entity might not benefit from CERCLA's lender liability protection because it is not a "lender" under CERCLA. A lender is defined under CERCLA as "any person…that makes a *bona fide* extension of credit to or takes or acquires a security interest from a nonaffiliated person." While one might argue that the affiliated entity is taking title to the real property to preserve the value of the affiliated lender's collateral, we have found no authority suggesting that Congress considered such an arrangement when it enacted the applicable amendments to CERCLA. Nor have we identified any judicial opinions directly addressing this issue. Consequently, if a lender wants to be sure that an affiliated entity will qualify for the lender liability protection under CERCLA, it should assign the loan to the affiliated entity prior to the time that entity takes title to the real property.

OTHER CONSIDERATIONS

Lenders should also consider whether they have liability exposure under applicable state law. While every state has CERCLA-like legislation that addresses the liability of PRPs for releases of hazardous substances, the breadth of such legislation varies considerably from state to state. The scope and availability of lender liability protections under state law may vary considerably from the exceptions available under CERCLA. For instance, under Massachusetts law, a foreclosing lender is expressly required to take certain actions if it obtains knowledge of a release of hazardous substances after it takes title to real property. In addition, under the Massachusetts lender liability exceptions, there is a presumption after foreclosure that the lender acted diligently to divest itself of ownership or possession of the property during the first 36 months after the lender acquired ownership. After the 36-month anniversary of foreclosure, the burden of proof shifts to the lender to demonstrate that it acted diligently to divest itself of ownership. Consequently, lenders should work with counsel familiar with the environmental laws of the state in which the subject property is located to evaluate the lender's potential liability exposure under CERCLA and state law before the lender takes a security interest in or forecloses on such property.

In addition to evaluating a lender's potential exposure to federal and state hazardous waste liabilities, lenders should conduct environmental due diligence before issuing a mortgage loan or taking a security interest in real property. Environmental due diligence allows a lender to evaluate whether there are environmental liability or compliance issues that could: (1) affect the borrower's ability to repay the loan; (2) harm the value, marketability or future use of the collateral; (3) impair the marketability of the loan; (4) financially drain the borrower's ongoing operations; or (5) create a reputational risk to the lender by associating the lender with a heavily contaminated site. <

WHAT REAL ESTATE LENDERS AND BORROWERS NEED TO KNOW,
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or more classes of impaired creditors where at least one other class of impaired creditors has approved the plan and the plan otherwise satisfies the requirements for confirmation by the court. While the threat of a cramdown is a mortgage lender's worst nightmare, as a practical matter it is often difficult for a debtor to achieve.

If all impaired classes approve the plan it will be confirmed, provided that it is feasible. A plan will be considered feasible if the court concludes that the debtor should be able to perform its obligations under the plan. With respect to secured mortgage loans, this usually requires some amortization and reasonable business terms. Under the cramdown provisions of the Bankruptcy Code a plan may be confirmed, notwithstanding the objection of impaired classes of creditors, if it is feasible, "fair and equitable," "does not discriminate unfairly" against the class or classes of dissenting creditors, and has been approved by at least one legitimate class of impaired creditors.

A plan is considered fair and equitable to a secured creditor if the secured creditor retains a lien against its collateral to the extent of its claim, receives deferred payments that total at least the face amount of its claim, and the deferred payments have a present value equal to or greater than the value of the secured creditor's interest in the collateral. A plan is fair and equitable to unsecured creditors if each senior class is satisfied in full (but not necessarily in cash) by obligations having a present value equal to the amount of its claim or, if not satisfied in full, if no junior class, including holders of equity interests, receives any payment or property under the plan. As a practical matter this means that without acceptance of a plan by the requisite majority of general unsecured creditors of a debtor the plan cannot provide any recovery for junior creditors or holders of equity interests until the senior classes of creditors are paid in full. This concept is generally referred to as the "absolute priority" rule.

It is important to note that not all discrimination between similarly situated classes of creditors is prohibited, only discrimination that is unfair. In order to evaluate whether proposed disparate treatment is permissible, courts look primarily to whether there is a reasonable basis for discriminating at all and, if so, whether the proposed disparate treatment is fundamentally unfair. For example, if a plan proposed to divide unsecured creditors into a class of trade creditors and a separate class of unsecured bondholders, and to provide for a distribution to both classes having a present value of 40 percent of their respective claims, with the sole difference being that trade creditors would get paid in cash while bondholders would receive new, interest-bearing notes, that likely would be viewed as reasonable and fair. It would be viewed as reasonable since trade creditors, whose cooperation the debtor will often need to run its going forward business, have an expectation to get paid quickly in the ordinary course, while bondholders expect to be paid over time. It would be fair since both classes would receive obligations having the same present value. Courts will also look to ensure that the classification was proposed in good faith and not for the purpose of creating an impaired class that will vote in favor of the plan as part of a scheme to permit the potential cramdown of other classes (this is often referred to as artificial impairment.)

CRAMDOWNS AND THE SINGLE ASSET BORROWER

The overwhelming fact of life for the single asset debtor is that its claims are usually dominated by a single mortgage lender. Debtors in this situation sometimes try to develop plans that treat the unsecured portion of the mortgage lender's claim as being in a separate class from other unsecured claims. The other unsecured claims are usually limited to trade creditors, and this raises the possibility that if the trade creditor class approves a plan it can be crammed down over the objection of the mortgage lender. While some courts have permitted separate classification of these claims, most bankruptcy courts that have faced the issue have denied confirmation of plans that classify a secured lender's deficiency claim separately from other unsecured claims.

Another problem for the equity owners of single asset entities is the absolute priority rule, described above. In a plan approved on the basis of a cramdown the equity owners are not permitted to retain their ownership interests in the debtor entity unless all objecting classes of creditors are paid in full. A case decided by the Supreme Court in the 1930s under older bankruptcy legislation created what came to be known as the new value exception to the absolute priority rule where the existing equity owners contribute new capital to the reorganized debtor. Subsequent court decisions have required that the contribution be in cash rather than deferred contributions or "sweat equity" and be reasonably equivalent to the retained interest.

It is particularly difficult for a single asset debtor to cram down a plan over the objections of its mortgage lender. This is due in part to the many hurdles placed in its path by the reorganization provisions of the Bankruptcy Code and in part

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ARE "HELL OR HIGH WATER" CLAUSES WATERTIGHT?, *CONTINUED FROM PAGE 6*

more than express Home Depot's knowledge regarding the integrity of the premises at the time of execution, notwithstanding the language whereby Home Depot certified that it had "fully inspected the Premises" and found them in good repair. Thus, the court concluded that the estoppel certificate did not preclude the tenant from asserting a constructive eviction defense where the tenant was unaware of a faulty condition at the time it executed the estoppel.

Evaluating the particular hell or high water clause at issue in the ReliaStar recognition agreement, the court carefully parsed the actual language of the provision, noting that the principal force of the language is the payment of "all rents" with such rents described as rents being "*due* under the Lease." The court's technical reading of the language here is a little curious in that it is difficult to imagine how different language would have produced a different result. For example, even if the hell or high water clause in the recognition agreement had been more explicit and provided that Home Depot was to pay all amounts regardless of the possibility of a constructive eviction claim (e.g., even if the rents were no longer *due* under the lease), it is possible that such a provision might strike a court as unconscionable — and therefore unenforceable — even in a commercial context with sophisticated parties.

The outcome of the ReliaStar case turned out to be fairly fact-specific, and whether Home Depot can now show its constructive eviction claim to have merit has yet to be seen. Nevertheless, even if broader language in the recognition agreement's hell or high water provision would not have rendered a different result, more specific language in the lease itself may at least help to defeat a defense of constructive eviction, particularly with respect to whether the tenant was to have accepted the building pad in its "as-is" condition, or whether it was given the opportunity to inspect the pad prior to constructing its store and thereafter was to assume all liability for any building pad failure. It is unclear whether the lease itself also contained a hell or high water clause or any waiver of claims language that may have included a waiver of constructive eviction; however, given that the court equated constructive eviction with fraud or duress, it seems unlikely that any such waiver language, if included, would have changed the court's reasoning or the result.

Landlords need to be cognizant of the importance of clearly setting forth the obligations and liabilities of the parties with respect to property condition, because to the extent a landlord remains obligated to deliver the property in a specific condition, there will remain a risk that such condition will fail and constructive eviction could terminate the lease, thereby defeating any no offset or defenses to payment of rent language.

Even for a commercial lease negotiated by sophisticated parties, the issue is not likely to be resolved with an explicit waiver of the constructive eviction defense, since it is possible that such a waiver may be held to be unenforceable as unconscionable or offensive to public policy. It is therefore critically important for both landlords and their lenders to be aggressive in negotiating and explicitly setting forth the obligations and liabilities of the parties, with the goal of eliminating ambiguity and making clear a tenant's obligations to pay rent under any and all circumstances. <

A YEAR OF CHANGES, *CONTINUED FROM PAGE 1*

the ability to refinance sharply inhibited, we are likely to see more defaults and foreclosures in 2010. And yet, we also expect to see more transactions involving companies looking at distressed real estate as an investment opportunity. According to the recently released fifth annual North American Distressed Debt Market Outlook Survey, "almost half of all poll respondents believed that the real estate sector will be the best sector for distressed investing opportunities this year." <

WHAT REAL ESTATE LENDERS AND BORROWERS NEED TO KNOW, *CONTINUED FROM PAGE 9*

to the protracted and costly litigation over classification of claims, valuation, interest rates and other matters that is the inevitable result of contested proceedings. The single biggest factor by far is typically the absence of a legitimate accepting impaired class of creditors. There are usually very few non-insider creditors other than the mortgage lender. As a result of these factors there appear to have been very few successful cramdowns in single asset cases. Perhaps the best chance exists where the mortgage lender is oversecured, and is not in a position to dominate the unsecured class of claims.

Despite the publicity about a few high-profile cases there continue to be very few Chapter 11 filings by single asset real estate owners. In part this may be due to the prevalence of "bad boy" guarantees by the principals, discussed elsewhere in this newsletter. Nevertheless, as covenant defaults on commercial property loans escalate into payment defaults many lenders are likely to pursue foreclosure, and more Chapter 11 filings may result. Lenders and borrowers will need to focus on the risks and rewards of contested proceedings as opposed to "prepackaged" plans and carefully consider strategies to maximize their advantages and minimize their risks and costs. <

BAD BOY GUARANTEES, *CONTINUED FROM PAGE 3*

the lender as a direct consequence of such breach. In *Princeton Park*, where the ultimate loan deficiency appears to have been unrelated to the triggering event that occurred under the guaranty, this distinction could have saved the guarantors from recourse liability. From a lender's perspective, the *Princeton Park* case further establishes bad boy guarantees as powerful tools in commercial real estate financing.

Whether you are a lender, borrower or guarantor, the following statement from the court perhaps best summarizes the cautionary lesson of *Princeton Park*:

> These are sophisticated defendants that were dealing at arms length when they signed the absolute and unconditional guaranty to govern the instances in which recourse liability would be triggered. The parties understood the provisions, and how they would operate, when they entered into the agreement, as they bargained for the opportunity to avoid recourse liability in certain instances, yet engaged in conduct that they knew would implicate personal liability if discovered. <

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