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Navigating Commercial Loan Forbearance Agreements

By Richard S. Fries and Todd B. Marcus

Increasingly commercial real estate owners are reaching out to their lenders for forbearance. Whether facing an impending loan maturity, loss of a significant tenant, capital improvement requirements, deferred maintenance or a materially softening leasing market, these property owners need loan relief. Loans may be current; there may be recourse in the nature of a well-capitalized guarantor; the lender may be secure that it is adequately collateralized and may have excellent remedies and no fear of utilizing them. Nonetheless the circumstances—business, legal and practical—may cry out for a fair, balanced and, most important, workable forbearance agreement.

This article sets forth a roadmap on what such a forbearance agreement should look like. While the strategies, objectives and provisions below are applicable to many types of secured loans, we limit the discussion to a commercial real estate loan made and held by a portfolio lender secured by a first mortgage on a single parcel of commercial property located in New York.

STRATEGIES

At its core, the forbearance agreement implements the following principle—in exchange for economic and legal concessions, the lender obtains certain credit or collateral enhancements and/or invokes its remedies. The lender concessions fall into the following categories: (1) restraint or forbearance from accelerating the loan and/or pursuing foreclosure and other legal remedies; (2) extension of the maturity date; (3) waiver of economic or covenant defaults; (4) suspension of required principal amortization and/or interest installment payments; (5) modification (i.e., reduction) of the interest rate, including a waiver, accrual, or accrual and forgiveness of default interest; (6) partial release of real estate collateral or agreement to accept release prices; (7) release of guarantors or reduction of the guaranty obligations; (8) reduction of the principal indebtedness or the opportunity to repay the indebtedness at a discount; (9) modification of covenants or capital requirements; or (10) an exchange of debt for equity in the borrower entity.

The enhancements obtained by the lender in exchange for the concessions include (1) additional collateral; (2) concessions or contributions from other lenders; (3) a new partial (or even full) guaranty of a previously non-recourse loan, debt service or other financial obligation; (4) an increase in the scope of guaranteed obligations, or additional specified "recourse" events; (5) additional loan covenants, financial reporting or monitoring

CONTINUED ON PAGE 6

IN THIS ISSUE

Current Trends in Multifamily Housing Finance

By Kenneth G. Lore and Martin Siroka

Due to the current economic downturn, multifamily rental housing is suffering from a severe scarcity of financing and capital. Although recently there have been some signs of an overall economic recovery, the multifamily housing industry's ability to recover will depend to a certain degree on the viability of existing and newly authorized government programs, including those of the Federal Housing Administration (FHA), Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac). This article reviews the current state of multifamily rental housing finance, summarizes governmental initiatives and programs that provide financing and assistance, and identifies initiatives that would further facilitate multifamily housing development.

THE STATE OF THE MARKET

While there are some signs of improvement, financing remains scarce. Many projects that would have been feasible on traditional underwriting terms prior to the current economic downturn cannot obtain financing today. Many projects that obtained construction financing prior to the credit crunch are still unable to secure permanent financing. Some of the factors leading to the scarcity of financing include:

- **Rents.** The rents used in underwriting projects financed only a few years ago are not yet achievable.
- **Vacancies.** In general, rental housing vacancy rates nationwide, as well as retail/office vacancy rates, have increased.
- **Troubled Condo Projects.** Many condominium projects undertaken in recent years have remained uncompleted and others, though completed, have remained empty or have been added to the rental pool.
- **Capitalization Rates and Valuations.** The increase in capitalization rates, coupled with the reduction in rents, has generally reduced appraised values. However, in some areas, capitalization rates have come back down and some are even approaching pre-recession levels.
- **Tighter Lending Standards.** Lenders are now typically applying much more stringent underwriting standards, including higher loan-to-value (LTV) and debt-service coverage ratios. Lenders (other than FHA, Fannie Mae and Freddie Mac) are now in many cases requiring LTV ratios for new construction loans in the 50 to 60 percent range, compared to 70 to 80 percent previously.
- **Increased Fees.** Lenders are charging higher interest rate spreads and higher loan, letter of credit and credit enhancement fees. During 2009, for example, Freddie Mac's credit enhancement/liquidity facility fees for variable rate tax-exempt bond transactions increased from less than 125 basis points to approximately 250 basis points. However, in 2010, Freddie Mac's fees have decreased and are approximating pre-2009 levels except for liquidity fees for variable rate demand bonds.
- **Buyer/Seller Disconnect.** Many owners are not willing to sell their properties at current values, while buyers are hunting for bargains.
- **Market Uncertainty.** Some investors are staying out of the market because of uncertainty as to values.
- **Drop in Low-Income Housing Tax Credit (LIHTC) Pricing.** Prices for LIHTCs have dropped substantially because the program's major investors have less income to shelter from taxes. Major players such as Fannie Mae and Freddie Mac are out of the market.

On the positive side, in addition to some signs of recovery in the credit markets, current market conditions—in particular, the combination of pricing, higher capitalization rates in some areas and low interest rates—may present opportunities for some purchasers.

FEDERAL BOND PROGRAMS

Congress and the Obama administration have instituted several programs to increase the use of tax-exempt bonds during the current recession. Under the New-Issue Bond Purchase Program (NIBP), Treasury is purchasing Fannie Mae, Freddie Mac and FHA-backed securities backed by tax-exempt housing bonds; under the Temporary Credit and Liquidity Program (TCLP), Fannie Mae and Freddie Mac provide replacement credit and liquidity facilities for existing bonds. Many state and local issuers of tax-exempt bonds for rental housing have collectively issued billions of multifamily housing bonds under NIBP; the proceeds of the bond sales have been placed in escrow and are being and will be used during 2010 to make multifamily mortgage loans. Unfortunately, to date very few multifamily projects have actually closed under the program. Greater volume is expected later in the year, and it is possible Treasury will extend the program.

CONTINUED ON PAGE 7

Subleasing in a Down Economy

By James L. Black, Jr.

A substantial amount of sublease space is available in many markets throughout the U.S. With a sluggish economy, many tenants have not experienced the business growth they anticipated when they originally entered into their leases or have been forced to downsize or consolidate their operations, resulting in excess or underutilized leased premises.

The boom-time scenario is familiar to the real estate community: when times were good and a tenant's business was expanding, the tenant entered into a large master lease in a prime location, counting on years of steady growth. With demand high, the landlord commanded a lofty rent for a long-term lease. Then, economic conditions deteriorated, leaving the tenant saddled with a high rent for the remaining term of a master lease that becomes a serious financial drain on its business.

For landlords, these circumstances are also a major cause for concern. Economic conditions have heightened the risk of tenant default or bankruptcy, which could deprive the landlord of cash flow needed to satisfy its debt-service obligations to its lender and leave it with the prospect of having to re-let space in its building. In addition, available sublease space might also compete with available direct lease space in the building. While sublease space is likely to be available at a lower rent than direct space, it poses an additional challenge to the landlord's ability to lease direct space in a difficult economic environment. A landlord might have the right to recapture space proposed to be sublet, but that right is only meaningful if the landlord is confident that it can secure a replacement tenant, which is a less certain prospect in today's economy.

To relieve some of the financial burden of carrying a master lease, many tenants have sought to negotiate a consensual early termination of their lease in exchange for the payment of a termination fee. However, if the landlord is concerned that it will not be able to find a satisfactory replacement tenant for the vacated space or the early termination will have an adverse effect on its present or future financing of the building, the landlord might not be willing to consent to an early termination. Also, a tenant might be in financial difficulty and not have available funds to pay a lump-sum lease termination buyout amount to the landlord.

Since an early termination may not be achievable, a tenant might pursue a sublease of all or a portion of its premises to mitigate its lease exposure. This presents opportunities for subtenants to acquire space at reduced rental rates. In a distressed market with a sizable amount of available sublease space, negotiating leverage has shifted to subtenants, especially those that are creditworthy.

The motivations for a subtenant are varied. A sublease might be an opportunity to bridge its space needs for a short duration without having to make a long-term commitment to a particular building or region. It might be a chance to upgrade to better space in a more desirable building for the same rent being sought for a direct lease in a less desirable space. A sublease could also be an opportunity for a tenant already leasing space in a building to expand into a neighboring tenant's leased space at a discounted price.

While the most obvious attraction for potential subtenants is the possibility of leasing space at below-market rates, there are other advantages. Some subleased space will come fully built out or furnished and therefore move-in ready without occupancy delays usually attendant to build-out periods. Furthermore, subtenants can usually get space for shorter terms than under a typical master lease. A subtenant may also be able to negotiate other positive financial terms beyond reduced monthly rent such as rent abatement periods, improvement allowances or reduced security requirements.

There are, of course, downsides for subtenants. The lease term may be very short and not include any options to extend or expand. The subtenant also may not be able to alter the space and can be restricted from further subletting or assigning its interest.

Another set of problems for subtenants is the result of the nature of the sublease itself. A sublease, by definition, is a contract between the existing tenant and the subtenant. The landlord is not a party to the sublease and, as a result, the sublease creates no "privity of contract" between the subtenant and landlord. This means that the subtenant cannot enforce the master lease directly. If, for example, the landlord fails to provide services such as cleaning common areas, the subtenant typically cannot sue the landlord directly. Instead, the subtenant should negotiate a provision in its sublease that requires the tenant to enforce the master lease on the subtenant's behalf. Further, if the direct tenant fails to pay rent or otherwise defaults, the master lease could terminate and the sublease will usually terminate along with

CONTINUED ON PAGE 8

Hoosier Decision: "Impossibility" Warrants Preliminary Injunction Against Payment Obligation

By Mia Weber Tindle

What right, and under what circumstances, does a third party have to enjoin the payment obligation of another? This issue was recently addressed by the U.S. Court of Appeals for the 7th Circuit, with a surprising outcome that may have negative implications for enforcement of letters of credit, the workhorse of the commercial security arena.

Transaction Structure

The underlying transaction in the case, *Hoosier Energy Rural Elec. Corp., Inc. v. John Hancock Life Ins. Co. (2009)*, involved a form of "synthetic" lease. Essentially, John Hancock made a loan to Hoosier Energy secured by a lease rather than a mortgage. John Hancock paid Hoosier $300 million for a long-term lease in Hoosier Energy's Merom electric generation plant. Hoosier in turn leased the facility back from John Hancock for a shorter period, making periodic payments with a present value of $279 million. The $21 million difference represented profit to Hoosier Energy and value to John Hancock in the form of depreciation deductions as the long-term tenant of the plant.

To hedge against the risk of Hoosier Energy's repudiation of the lease in the event of a bankruptcy filing, John Hancock required that Hoosier Energy provide a credit default swap (CDS) and a surety bond, both issued by Ambac. Like a letter of credit, a CDS assures payment to the beneficiary when certain contingencies occur and without proof of loss. Ambac and its affiliates agreed to pay John Hancock $120 million if certain events occurred as a direct obligation to John Hancock. Hoosier Energy separately posted substantial liquid assets to Ambac's credit in the event Ambac was required to pay John Hancock.

One of the contingencies to the CDS was maintenance of Ambac's credit rating above a prescribed threshold. Where it slipped below that threshold, Hoosier Energy was to find a replacement for Ambac within 60 days. If no replacement was found within the 60-day period, then Ambac was required to pay John Hancock the full amount due under the CDS upon John Hancock's demand.

Impacts of the Financial Crisis

During the 2008 credit crisis, Ambac's credit rating did indeed slip, and John Hancock demanded that Hoosier Energy find a replacement surety. When Hoosier Energy reported trouble with locating a replacement, the deadline was extended. At the arrival of the extended deadline, Hoosier Energy indicated it was in negotiations with a third party having very highly rated financial standing to replace Ambac but hadn't yet secured a commitment. Since the contingency was not met, John Hancock called on Ambac to perform. Ambac indicated it was ready, willing and able to perform its obligations under the CDS. Hoosier Energy then filed suit and obtained a temporary restraining order, later converted to a preliminary injunction, forestalling Ambac's payment. Hoosier Energy alleged that if Ambac paid John Hancock on the CDS (approximately $120 million), then Hoosier Energy would be required to cover the outlay under its independent obligation to Ambac, which would drive Hoosier Energy into bankruptcy. The lower court found this to be an "irreparable injury" justifying a preliminary injunction.

Third-Party Standing to Enjoin Payment

Key to the court's holding was its analysis of two core issues: (1) it found Hoosier Energy to have standing to enjoin Ambac's payment to John Hancock under the CDS even though Hoosier Energy was not a direct contractual party, and (2) it determined there could plausibly be an argument on the merits that would enable Hoosier Energy to prove it was "impossible" to find a replacement surety intermediary in light of the 2008 global economic crisis. Both of these findings have troubling implications as to enforcement of CDSs and, by analogy, letters of credit.

Both a CDS and a letter of credit are tools that shift the risk of payment from one party to another, entitling the beneficiary to look to the creditworthiness of the bank or surety as opposed to that of the borrower or the lessee. The bank or surety is obligated to pay the beneficiary simply upon the presentation of a conforming draw or demand. The underlying transaction and its vagaries are not within the purview of the bank, nor is the payment treated as funds of the debtor in a bankruptcy proceeding of the borrower/lessee.

For example, a savvy leasing lawyer representing tenants will advise that the form of letter of credit posted as security be agreed to in advance, typically as an exhibit to the lease, with an express provision requiring a landlord certification that the tenant/obligor is in default under the subject lease as part of any draw request. Even this modest hurdle does not

CONTINUED ON PAGE 9

The *TOUSA* Decision: A Lender's Nightmare?

By Marc Anthony Angelone

The nightmare: $500 million in secured loans challenged in bankruptcy court; all claims by lender against borrower and all liens avoided; all principal, interest, costs, expenses and other fees, including all professional fees paid to lender in connection with the loan, disgorged; $403 million, plus nine percent pre-judgment interest, disgorged; all loan transaction costs, litigation costs (including attorney fees, adviser fees and expert fees) and diminution of value in property incurred by borrower to be paid by lender; a lien on a $207.3 million federal tax refund avoided and all funds paid from such tax refund disgorged with nine percent interest.

This laundry list of woes was the painful reality for the lenders in *In re TOUSA, Inc.* (the "*TOUSA* decision"). The *TOUSA* decision is a 182-page ruling by the U.S. Bankruptcy Court for the Southern District of Florida (the "Court") finding that the loans made by the secured lenders in that case were constructively fraudulent transfers.

This article will provide a brief summary of the relevant facts, the implications of the decision and the lessons to be learned from the case. Of particular note is that the Court (1) dismissed the savings clauses contained in the loan documents as unreasonable and unenforceable devices; (2) found the solvency opinion relied upon by the lenders to be ineffective; and (3) as part of its remedy, ordered the lenders to pay the borrower for the diminution of value in its property from the time of the granting of the liens to the date of the decision of the Court.

BACKGROUND

TOUSA, Inc. and its subsidiaries were in the business of designing, building and marketing detached single-family residences, town homes and condominiums. The case involved an "upstream guarantee" by certain subsidiaries of TOUSA (the "Conveying Subsidiaries") pledging their assets as collateral to secure the obligations of TOUSA to repay roughly $500 million in first and second lien term loans (collectively, the "Term Loans"). The proceeds of the Term Loans were used to settle litigation against TOUSA and one of its subsidiaries ("Homes LP"). That litigation arose from a default on separate debt incurred to finance a failed joint venture enterprise. Notably, none of the Conveying Subsidiaries was a party to the lawsuit brought by the entities that financed the failed joint venture enterprise (the "Transeastern Lenders") for which the settlement funds were being paid. However, the Conveying Subsidiaries granted liens on the majority of their assets to secure the funds borrowed to settle this litigation. TOUSA, Homes LP and the Conveying Subsidiaries declared bankruptcy six months after the loans were made by the Term Loan lenders. TOUSA's official committee of unsecured creditors, representing approximately $1 billion in unsecured bond debt, brought suit to avoid the Term Loans and the Transeastern Lenders settlement as fraudulent conveyances.

FRAUDULENT CONVEYANCES

Section 548(a)(1)(B) of the U.S. Bankruptcy Code permits the avoidance of any transfer of interest in debtor property, or any obligation incurred by a debtor, that was made or incurred within two years before the date of filing a bankruptcy petition if the debtor voluntarily or involuntarily received less than reasonably equivalent value in exchange for such transfer or obligation and (1) was insolvent on the date the transfer or obligation was incurred, or became insolvent as a result of such transfer or obligation; (2) was engaged in a business or transaction, or was about to engage in a business or transaction, for which any property remaining is unreasonably small capital; or (3) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured. No actual fraud or intent to deceive is required.

The Court reasoned that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the Term Loans because they received neither direct nor indirect benefits from the Term Loans. With respect to direct benefits, the Conveying Subsidiaries were not parties to the litigation that was being settled, and they received no proceeds from the Term Loans, no debt relief and no tax benefits. With respect to indirect benefits, the Court stated that indirect benefits are cognizable only if (1) the benefit is actually received by the individual subsidiary, (2) the benefits are limited to cognizable "value" and (3) the property is received by the subsidiary "in exchange for" the transfer obligation. Based on these criteria the Court dismissed the defendants' assertions that corporate office services, business "synergies" and "avoiding default" constituted the cognizable indirect benefits of a common business enterprise.

After a very lengthy analysis, the Court also determined that each Conveying Subsidiary (1) was insolvent both before and after the loan transaction—"[t]o decide whether a firm is

CONTINUED ON PAGE 10

NAVIGATING COMMERCIAL LOAN FORBEARANCE, *CONTINUED FROM PAGE 1*

rights; (6) a lock box or the triggering of use of a lock box feature; (7) the cure of legal, document or perfection deficiencies (such as ratification of the indebtedness or guaranties); (8) control of the project revenue (cash collateral) through a cash management agreement; (9) a cash flow sweep tied to an approved budget, controlled expenditures, or a new or improved revenue stream; (10) a capital infusion; (11) ratification of the loan documents, borrower obligations and the priority of the lien of the mortgage; (12) waiver and release of defenses and counterclaims; and (13) consent to remedies such as a judgment of foreclosure, a guarantor's confession of judgment, a consent to vacate the automatic stay in bankruptcy, a consensual receivership, or a consensual sealed bid or other auction of the mortgaged property upon the occurrence of a subsequent material default.

The foregoing categories of concessions and enhancements have made the negotiation and implementation of an effective, workable and fair forbearance agreement an art form.

ESSENTIAL PROVISIONS

The "state of the art" commercial real estate loan forbearance agreement should include the following essential provisions:

- **Acknowledgment of Indebtedness**

  The lender's "ticket for admission" to its grant of forbearance is the acknowledgment by borrower and guarantor (if any) of the existing debt. Borrower and guarantor must acknowledge and agree that the outstanding principal balance of the note or notes, together with all accrued interest thereon, legal fees and all other sums due under the loan documents are immediately due and payable in full without defense, offset, claim or counterclaim of any kind.

- **Ratification of Loan Documents**

  The lender wants to cure all conceivable loan or document defects, such as incomplete signatures or failures to perfect its security interests. Thus, the borrower and guarantor will ratify, confirm and acknowledge the validity and binding nature, both at the time of delivery and as of the execution of the forbearance agreement, of all loan documents, as amended, modified or supplemented. The borrower and guarantor will acknowledge that all of their financial obligations are duly and properly secured by mortgages and all other security or collateral instruments for the full extent thereof, without defense, offset or counterclaim, as well as the priority of the lender's lien on the mortgaged property. They will also acknowledge that defaults have occurred, that the lender reserves all of its legal rights and remedies, and that the lender has no obligation to tender the terms of forbearance set forth in the agreement.

- **Forbearance Expiration Date**

  The forbearance is borne of a loan default that is material enough for the lender to have the right to pursue its remedies. In the forbearance agreement, the lender agrees to forbear from the exercise of its remedies until a negotiated date is certain. This provision also should provide that nothing prevents the lender from exercising its legal remedies upon the occurrence of a new or subsequent default under the forbearance agreement.

- **Suspension of Payments—Note Rate—Pay Rate**

  A key economic component of the forbearance agreement is the modification or suspension—for the term of the forbearance, or beyond—of the contractual debt service installment payments, tied generally to cash flow, capital improvements or deferred maintenance needs, or the marketplace. Often the lender suspends or defers the principal amortization or principal reduction payment dates. The interest rate may be modified to provide immediate "rate relief" and cash flow.

  The savvy lender generally suspends (or reduces) the monthly principal installment payments and modifies interest into a "note rate/pay rate" model by which interest continues to accrue at the contract rate (which could be the default rate under the loan documents), but the borrower pays interest at a lesser or "pay" rate. The difference is accrued and paid either at the forbearance expiration date or other date certain or, more commonly, capitalized and repaid over the balance of the loan term. Sometimes the interest shortfall is forgiven once the borrower has performed its obligations and repaid the indebtedness. This accrual—especially if the loan is recourse to well-capitalized guarantors—functions as additional leverage for the lender and economic motivation for the borrower to perform.

- **Additional Collateral or Additional Guaranties**

  In any workout, the lender is likely to request additional collateral or additional guaranties. Collateral could consist of interests in other real property, membership

CONTINUED ON PAGE 11

CURRENT TRENDS IN MULTIFAMILY HOUSING FINANCE, *CONTINUED FROM PAGE 2*

FHA AND SECTION 8

Historically, the most significant federal programs to encourage the development of multifamily housing were FHA mortgage insurance provided by the Department of Housing and Urban Development (HUD) and project-based rental assistance from HUD under its Section 8 program.

Since the late 1980s, FHA's subsidized housing focus has been on retaining existing projects within the affordable housing portfolio. Under its Section 236 decoupling program, HUD continues mortgage interest rate subsidies, in effect following the refinancing of the original HUD-assisted mortgage, in exchange for extension of low-income affordability restrictions. Under HUD's Section 8 mark-up-to-market program, HUD increases Section 8 contract rents to market levels to induce owners to stay in the Section 8 program.

These federal initiatives often operate in conjunction with state and local preservation efforts. As an example of what can be accomplished when there is a strong public commitment to preservation, in mid-December 2009, Bingham represented Starrett City in Brooklyn, the nation's largest federally assisted housing project, in a refinancing transaction that involved a Section 236 decoupling, a new Section 8 mark-up-to-market contract and a long-term extension of affordability under the New York state Mitchell Lama program.

FHA financing provides construction/permanent 40-year nonrecourse mortgages with low equity requirements, attractive debt-service coverage ratios (1.1 debt-service coverage (DSC) for new construction/substantial rehabilitation loans, soon to be increased to 1.15 DSC for LIHTC projects and 1.20 DSC for market-rate projects), and mortgage insurance premiums (MIP) that are quite low (currently, 45 basis points per year for most new construction/substantial rehabilitation loans) compared to non-FHA credit enhancement. While FHA does not permit variable rate mortgage debt, this limitation is not as significant at the current time due to the historically low rates for fixed-interest debt.

The volume of FHA new construction and substantial rehabilitation projects declined by more than 50 percent between 2003 and 2008. The recent unavailability of other financing sources has resulted in increased FHA volume (except in high-cost areas such as New York, Washington, Boston, Los Angeles and San Francisco). The very low levels of FHA new construction and substantial rehabilitation activity in these high-cost areas is almost certainly due to statutory limitations on mortgage amounts, which have not been increased to compensate for the high development costs in those areas. By contrast, as part of its stimulus legislation Congress substantially increased single-family FHA and Fannie Mae/Freddie Mac mortgage limits to levels sufficient to make those programs available to homeowners, even in relatively well-off neighborhoods in high-cost areas.

On March 16, 2010, HUD revised its underwriting policy and announced that the total land value will be excluded from the calculation of the statutory mortgage limits for FHA multifamily mortgage insurance, thus potentially resulting in larger FHA mortgage amounts especially in areas that have high land costs. The exclusion of land value in the mortgage-limit calculation announced by HUD, while a helpful step, will need to be coupled with statutory changes in the mortgage limits in order to substantially increase the availability of FHA financing in areas with very high development costs.

On Sept. 15, 2009, the House of Representatives passed H.R. 3527, the "FHA Multifamily Loan Limit Adjustment Act of 2009," sponsored by Rep. Anthony Weiner (D-NY), to substantially increase mortgage limits for elevator buildings and projects in high-cost areas. Sen. Charles Schumer (D-NY) recently introduced a parallel amendment to the financial regulatory reform legislation. Although the amendment was withdrawn, Sen. Schumer is reportedly interested in finding another legislative vehicle for the amendment. The enactment of such legislation, coupled with HUD's recently announced policy change excluding the total land value from the mortgage limit calculation, would greatly enhance the availability of FHA financing for multifamily construction in high-cost areas.

LOW-INCOME HOUSING TAX CREDITS

Since its enactment as part of the Tax Reform Act of 1986, the LIHTC has been the federal government's primary tool to encourage the development of affordable multifamily housing, leading to the development of more than two million housing units. Most of the affordable projects financed during the past 20 years have utilized the LIHTC to provide additional equity.

Prior to the current downturn, about 40 percent of LIHTC investments came from banks and another 40 percent came from Fannie Mae and Freddie Mac. These institutions have reduced their investment in LIHTC projects as their need to offset taxable income has declined. In certain areas,

CONTINUED ON PAGE 13

SUBLEASING IN A DOWN ECONOMY, *CONTINUED FROM PAGE 3*

it. In short, the subtenant is relying on the tenant to perform its contractual obligations under the master lease. A non-performing or financially tenuous tenant can put the entire sublease at risk.

The tenant is the middleman in a sublease transaction. The sublease gives the tenant the opportunity to pass through to a subtenant all or a portion of unwanted space and related lease expenses. However, the tenant will not be relieved of its lease obligations and will remain liable for its obligations as tenant under the master lease, as though the sublease had never been executed. The tenant may be responsible to the landlord for the subtenant's actions—even though the tenant may have little control over the subtenant. For example, a subtenant's holdover beyond the sublease term could result in the tenant's responsibility to the landlord for holdover payments under the master lease, which are often 1.5 to 2 times rent. The landlord's holdover remedy against the tenant might apply to the entire leased premises even if most of the leased premises are vacated but a subtenant of a small portion of the leased premises holds over. Accordingly, in the sublease, a tenant needs to be careful to negotiate protections in the event of subtenant breaches after giving due consideration as to how those breaches could expose the tenant to liability under the master lease.

In addition, the tenant must perform as sublandlord to the subtenant under the sublease and thus incurs additional liabilities to a third party. The tenant would be well-advised not to assume the obligations of the landlord under the lease (such as the provision of building services or rebuilding upon a casualty), which are out of its control. Instead, the tenant should simply agree to use reasonable efforts to enforce those provisions against the landlord.

For landlords in a down market, subleases are often exercises in minimizing risk. A landlord might consent to a sublease (or even recognize a subtenant directly) if the tenant is in financial difficulty and the subtenant is creditworthy. If the tenant defaults and the master lease terminates, a landlord might prefer to require the subtenant to continue to perform and pay rent directly to the landlord and not have the ability to walk from its sublease obligations. A landlord is generally less inclined to recognize a subtenant if it has a strong and creditworthy direct tenant.

The landlord's rights in respect of a proposed sublease will depend on the negotiated subletting provisions of the master lease. Because the wrong subtenant can affect the quality or tenant mix of the entire building, particularly in a shopping mall or other retail space lease context, the landlord usually will have limited the tenant's sublease rights in the master lease. Whether a landlord has approval rights over a proposed sublease (or must exercise those approval rights reasonably) will impact the negotiating posture of the landlord. At the beginning of sublease negotiations the tenant and subtenant should have a clear understanding of those provisions and any conditions the landlord might impose. The tenant and subtenant also need to evaluate whether the landlord has any recapture rights or rights to any excess sublease profits. In a down economy, sublease rent is generally unlikely to exceed the corresponding master lease rent (and the landlord is usually less inclined to recapture space), but it is prudent to know the landlord's rights up front.

Subleases are often highly negotiated and address many issues similar to those in direct leases, but they also involve some unique issues. One of the complexities of the sublease is that it addresses only a subset of rights and responsibilities from the master lease. This is unlike an assignment, which is a transfer of the entire interest of the tenant in its lease and premises. Typically, the sublease will incorporate (by reference) the terms of the master lease as though the subtenant were the tenant, the tenant were the landlord and the subleased premises were the premises. The interplay of the master lease and the sublease must be carefully orchestrated to ensure the correct package of rights and obligations is being passed along to the subtenant, and that the tenant does not assume responsibilities outside of its control because it's not the building owner.

Subleases usually require the consent of the landlord. Tri-party negotiations among the landlord, tenant and subtenant add to the complexity and timeline of the sublease transaction. A detailed landlord consent document is often negotiated among the three parties. This document creates contractual privity between the landlord and subtenant, and it might create rights and obligations among the parties beyond those set forth in the lease or sublease. The landlord consent document might contain provisions beyond a simple consent to the sublease. It also might address other matters for which landlord's consent is necessary such as the subtenant's alterations, the subtenant's signage and the specific use of the premises to be made by the subtenant.

Since any termination of the master lease usually wipes out the sublease, a subtenant that has some negotiating leverage may want to pursue a recognition agreement with the landlord whereby the landlord will agree to recognize the sublease and the subtenant's rights to continue to occupy

CONTINUED ON PAGE 14

Hoosier Decision, *continued from page 4*

subject the bank to liability if in fact the tenant is not in default; the bank is entitled to rely on the certification by the landlord, and the draw will be honored. Rather, the requirement provides a basis for a claim by the tenant against the landlord, not against the issuing bank, if the tenant disagrees and takes the position that there was no tenant default.

The *Hoosier* decision casts doubt on the fundamental premise as to the independence of the CDS or letter of credit structure. In finding Hoosier Energy to have standing to not only object to, but also forestall, the payment obligation of Ambac, the court opined the underlying transaction had "three corners." While the structure involved "nominally independent contracts," the court affirmed Hoosier Energy's standing to enjoin Ambac's payment because "it would press legal fiction beyond the breaking point to say that the independent enforceability of each party's promises to the others meant that any of the three lacked standing to complain about acts of the others that will produce an immediate concrete injury."

MISSION "IMPOSSIBLE"

The court next turned to the potential merits of Hoosier Energy's claims. It rejected the lower court's first finding that the leveraged lease transaction itself was invalid. The court did, however, grant partial relief to Hoosier Energy, upholding the lower court's finding that "temporary commercial impracticability" could potentially permit Hoosier Energy to defer replacing Ambac while the economy improved.

Hoosier Energy claimed it had a duty under the CDS to find a higher-rated surety to replace Ambac, while the 2008 economic crisis made it commercially infeasible to find a replacement. Hoosier Energy presented a relatively novel argument in American courts, namely that the crash of the credit markets equated to an unforeseen event that should temporarily relieve Hoosier Energy of its obligations under the CDS. John Hancock argued that the contingencies under the CDS were designed to protect against the financial distress of both Hoosier Energy and Ambac, and that when this event materialized in the form of the lowered credit rating of Ambac, it was entitled to the benefit of the draw it had negotiated. John Hancock characterized Hoosier as having an option: either it could find a replacement surety, or it could pay Ambac.

In *Hoosier*, the court noted that "temporary commercial impracticability" is not a doctrine recognized under New York law, which was applied in the case. Instead the court used a related doctrine of "impossibility." Under New York law, the defense of impossibility only works "if some unexpected event upsets all parties' expectations; it is not enough that the unexpected event puts one side in a bind." Therefore, the court reasoned that if Hoosier Energy in fact had an *option* to find a replacement surety or pay Ambac on the swap feature, then it would not be entitled to relief. On the other hand, if Hoosier Energy could prove that (1) it in fact had a *duty* to find a replacement surety, as opposed to just the option to pay sums owed to Ambac as John Hancock claimed, and (2) as a result of the financial crisis, it was impossible to find such a replacement, then Hoosier Energy might win on the merits and have a defense to the payment by Ambac to John Hancock. On this basis, the court upheld the preliminary injunction to Ambac's payment to John Hancock, stating, "[I]f no one could have foreseen the extent of the credit crunch of 2008—and if it *really* made performance impossible...then the sort of argument Hoosier Energy makes could satisfy the requirements of [the impossibility defense]."

ENFORCEABILITY OF LETTERS OF CREDIT AT RISK?

The court did grant significant partial relief to John Hancock. While it upheld the lower court's grant of a temporary injunction, it also concluded that failure by Hoosier Energy to find a replacement for Ambac by some certain period (the court chose the end of 2009) would entitle John Hancock to realize on its security. Subsequent to the ruling, the injunction was dismissed altogether. While significant in the factual context of the case, this relief provides little comfort to lenders and other beneficiaries looking for certainty in the front-end enforcement of their security arrangements with borrowers and other obligors.

The court's finding that Hoosier Energy had standing to enjoin the payment obligation of its surety to the beneficiary under the CDS runs counter to the *de rigueur* independent treatment a CDS or, by analogy, a letter of credit, is given every day by parties who deal regularly with their issuance. Perhaps more troubling is the court's determination that disruptions in commercial markets as a whole could, in certain circumstances, give rise to a defense to payment under a CDS and, presumably, a letter of credit. <

THE *TOUSA* DECISION, *CONTINUED FROM PAGE 5*

insolvent…a court should ask: What would a buyer be willing to pay for the debtor's *entire package* of assets and liabilities. If the price is positive, the firm is solvent; if negative, insolvent"; (2) had unreasonably small capital after the transaction—"[the] standard asks whether a company has sufficient capital to support operations in the event that performance is below expectations…[b]alance sheet insolvency is also proof that the Conveying Subsidiaries had unreasonably small capital"; and (3) was unable to pay its debts as they became due—they actually were unable to meet their financial obligations after the transaction.

SAVINGS CLAUSES INVALID

The loan agreements for each of the Term Loans contained savings clauses that the Court found to be ineffective. The savings clauses in question purported to amend the liabilities and liens to the degree necessary to make them "enforceable to the maximum extent" permitted by law. The Court determined that those clauses were unenforceable, stating, "[t]here is something inherently distasteful about really clever lawyers overreaching…[s]ome problems cannot be drafted around….[The savings clauses] are, in short, entirely too cute to be enforced." The Court stated that because the Conveying Subsidiaries were insolvent even before the transaction and received no value, the liabilities and liens could not be enforced at all. Any liabilities imposed and any liens securing those liabilities were avoidable. The Court went on to say that even if the Conveying Subsidiaries had become insolvent after the transaction, the savings clauses would be unenforceable under 11 U.S.C. 541(c)(1)(B), which says that an interest of the debtor in property becomes property of the estate, notwithstanding any "provision in an agreement" that is "conditioned on the insolvency or financial condition of the debtor" that "affects or gives an option to effect a forfeiture, modification or termination of the debtor's interest in property." The Court held that these savings clauses were just the type of provisions that the Bankruptcy Code protects against. If the clauses were given effect, they would defeat the debtors' cause of action for a fraudulent transfer "and a cause of action is unquestionably property of the debtor." The Court believed that these savings clauses were unenforceable provisions that attempted to contract around the core provisions of the Bankruptcy Code and were invalid. Finally, an important factor in the Court's decision to reject these clauses was that both Term Loans contained identical savings clauses, which stated that the secured obligations to be preserved could not be determined under either loan until the liabilities had been determined under the other loan. The Court found that this circular cross-reference scheme made the liabilities inherently indeterminable and therefore impossible to enforce.

SOLVENCY OPINION UNRELIABLE

As part of their underwriting process, the Term Loan lenders required a solvency opinion. However, the Court found that the solvency opinion lacked credibility and that the lenders should not have relied upon it because (1) most importantly, the fee to be paid to the firm rendering the opinion was contingent on the conclusion—if the opinion showed solvency, the fee was $2 million; if insolvency, the firm would only be paid for its time and reimbursable expenses; (2) the firm lacked recent experience in providing such opinions—it had not prepared one in more than two years; (3) the borrower did not consider any other firm to provide the opinion; (4) the opinion was delivered in a suspiciously hurried manner—the firm was retained on June 15, informed TOUSA that the result would be favorable on June 20 and a draft solvency opinion was in circulation by June 27; and (5) the opinion relied on projections provided entirely by TOUSA's management and was not a "bottoms up" analysis. The engagement letter stated that the firm "would not take any action to verify accuracy or completeness" of the information provided, the firm did not ask management how good the projections had been historically, the information was not provided by operational-level management and, even though TOUSA acknowledged that due to the decline in the economy its projections were outdated and overly optimistic, it never revised its assumptions. The Court concluded that because the firm blindly relied upon TOUSA's unsupportable financial projections, its opinion that TOUSA was solvent as of July 31, 2007, was not credible.

DIMINUTION OF VALUE RECOVERABLE

In this case the timing is particularly interesting. The transaction was concluded in July 2007—just ahead of the major events of the recent financial meltdown. No one could have clearly foreseen the length and extent of the resulting economic collapse at that time. When the Term Loans were made, the value of the Conveying Subsidiaries' assets appeared to be greater than the obligations secured. However, by the time of the *TOUSA* decision, the value of those assets had greatly decreased below the value of the loans. The Court, in an effort "to restore the estate to the financial condition that would have existed had the transfer never occurred," employed its broad equitable powers to

CONTINUED ON PAGE 14

NAVIGATING COMMERCIAL LOAN FORBEARANCE, *CONTINUED FROM PAGE 6*

interests, marketable securities, tax refunds, litigation recoveries and condemnation awards, among other assets. Lenders also will seek new or additional recourse against the borrower's principals or investors via a new or amplified guaranty.

- **Discounted Repayment Option**

  Borrowers need to re-create equity lost during this down cycle. Depending on the parameters of the forbearance agreement, the borrower utilizes this stage of the workout to bring to the lender its primary objective—payment on a date certain. This objective comes at a price: the loan discount. Hypothetically, a $50 million loan secured by a $75 million asset may now be secured by a $40 million asset. In the discounted repayment scenario, the borrower offers to repay the loan at a discount, say, $38 million—retaining $2 million of equity upon a sale. The benefit to the lender is the realization of $38 million on a fixed date, achieved in an open and spirited (albeit soft) marketplace, which is preferable to the delay, uncertainty and risk of foreclosure or a deed in lieu of foreclosure. If the lender does not receive the discounted repayment amount by the discounted repayment deadline, or if the borrower or guarantor otherwise default, the agreement will provide that the lender's obligation to accept the discounted repayment amount in satisfaction of the indebtedness is withdrawn, null and void, and of no further force or effect.

- **Waiver of Defenses and General Release**

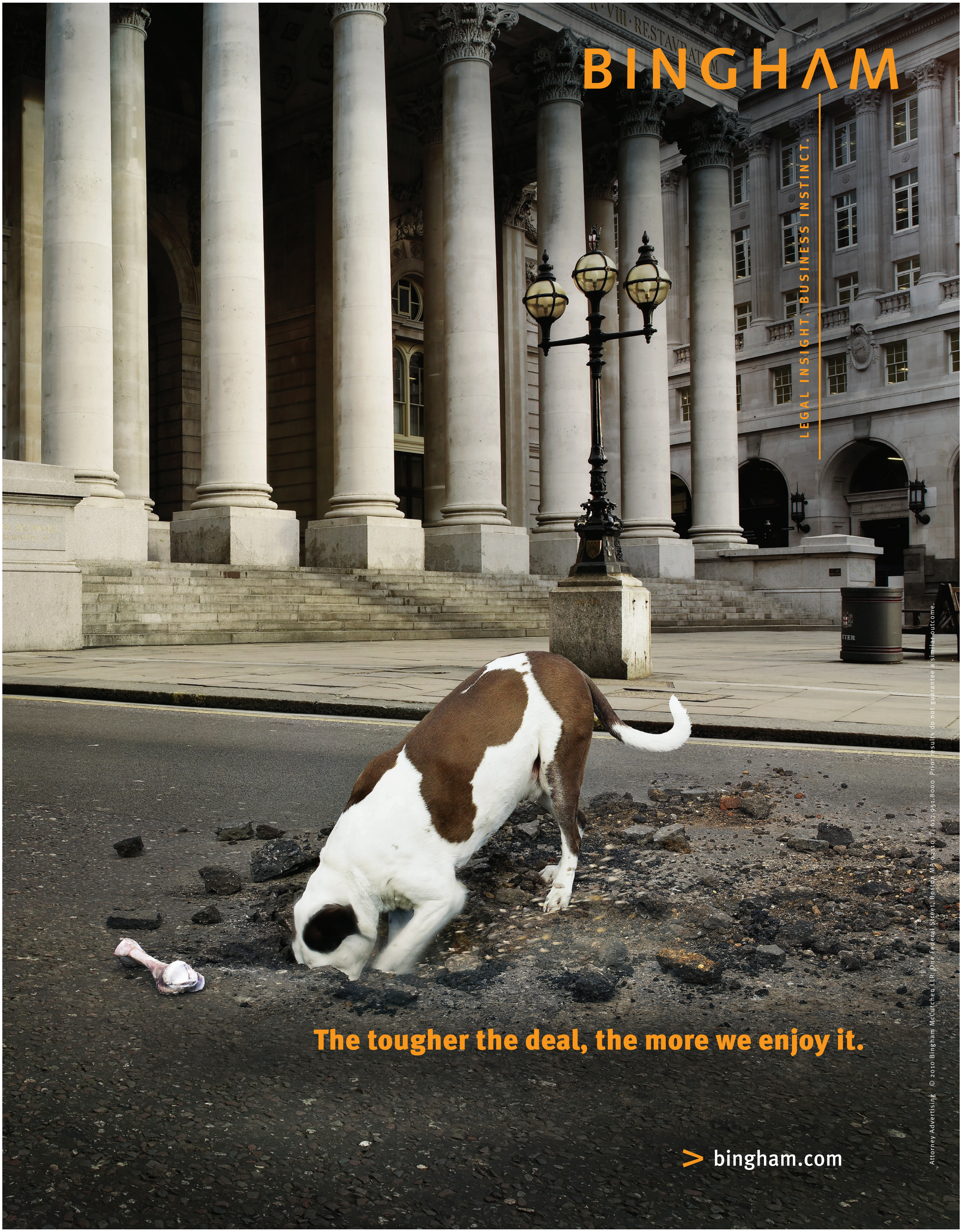
  The prudent lender will not make any significant economic concessions or grant meaningful forbearance unless the lender is assured of a clean slate when the forbearance period has expired. The borrower—looking for the lender's forbearance—should acquiesce. The forbearance agreement should provide that the borrower and guarantors waive and release all defenses to repayment of the indebtedness and unconditionally and irrevocably release, discharge and acquit the lender and persons and entities affiliated therewith from and against all claims, causes of action, liabilities or damages, known or unknown, relating to the loan documents, the obligations evidenced or secured thereby, the mortgaged property, the dealings between the parties, or any matters relating thereto.

- **Consent to Remedies**

  The successful forbearance agreement should contain the borrower's and guarantor's consent to remedies. The remedies include acceleration; receivership; consent to foreclosure judgments; confessions of judgment; exceptions to New York's election of remedies rules; enforceability of "bad boy" guaranties; and the consent to vacate the automatic stay in bankruptcy.

Depending on the circumstances, the borrower could, in the forbearance agreement itself, accept service of process, waive defenses to the complaint, consent to lender's computation of the indebtedness, consent to the appointment of a receiver or third-party property manager, consent to sale of the mortgaged property at auction and the turnover of possession to the purchaser, and agree not to seek to adjourn or hinder the entry of the foreclosure judgment or the conduct of the foreclosure sale or any other liquidation of collateral. The borrower would also acknowledge that its consent to these remedies is a material inducement to the lender for its grant of forbearance privileges and other economic concessions, on which the lender relies to its detriment.

In any loan workout, the parties need to reconcile, amicably, their contrary objectives (the borrower seeks time, equity in the project and release of personal liability; the lender seeks payment, finality and predictability). The forbearance agreement is an important, sometimes dispositive, step in this process. The essential provisions outlined above are valuable tools to consider as the parties strive to make the distressed loan workout work. <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CURRENT TRENDS IN MULTIFAMILY HOUSING FINANCE, *CONTINUED FROM PAGE 7*

Community Reinvestment Act (CRA)-motivated banks are once again participating in the LIHTC program and are providing favorable pricing.

Due to the withdrawal of major banks, Fannie Mae and Freddie Mac from the LIHTC market, capital generated from LIHTC investments has dropped by almost 20 percent.

In 2009 Congress responded to the collapse of the LIHTC market by enacting two provisions as part of the American Recovery and Reinvestment Act (ARRA):

- Under the Tax Credit Assistance Program (TCAP), HUD was authorized to provide $2.25 billion in HOME Investment Partnership funds to fill financing gaps in projects with LIHTC allocations.
- Under the Tax Credit Exchange Program, states may exchange a portion of their 2009 LIHTC allocation for cash grants at an exchange rate of 85 cents on the dollar, which states may then allocate to affordable housing projects. Continued softness in the LIHTC investor market nationally has led to calls for legislation to extend the exchange program and modify the program to broaden the LIHTC investor base.

  While this program has been an important stopgap measure, there is concern in the industry that it could be the first stage in a shift by Congress away from support for the LIHTC program in favor of a grant program, which would be subject to the uncertainties of annual appropriations and other issues.

CONCLUSION

The availability of financing is the most critical issue currently facing multifamily housing. Because conventional financing was unavailable (and now is beginning to be available at low LTVs), FHA mortgage insurance and other governmental programs are critically needed. On the federal level, while Fannie Mae and Freddie Mac continue to play a vital role in providing multifamily financing, the more stringent underwriting standards, significantly higher fees and rates, more restrictive terms under current programs, and unwillingness to take construction and rent-up-risk, make the availability of FHA multifamily financing for high-cost area projects a critical missing element. FHA financing will continue to be unavailable for projects in high-cost areas unless FHA multifamily mortgage limits for these areas are further increased.

On the equity side, proposed legislation to broaden and strengthen the LIHTC program would help ensure pricing firmness for LIHTCs.

Despite the slowdown, market-rate and affordable multifamily housing has been less risky than other commercial real estate. If interest rates remain comparatively low and rents continue to stabilize or increase, the current market may present attractive opportunities for purchasers of multifamily projects. <

THE *TOUSA* DECISION, *CONTINUED FROM PAGE 10*

order the lenders to also reimburse to the Conveying Subsidiaries the difference in the value of their assets from the time of the granting of the liens and the time the decision was delivered (Oct. 13, 2009). This diminution in value amount (which had not yet been calculated at the time of the ruling) will undoubtedly result in a significant additional liability for the lenders that they had not anticipated at the time of loan origination.

SUMMARY AND LESSONS

While the *TOUSA* decision highlights the risks of using the assets of subsidiaries to secure parent-level debt, most of its lessons are not new. Nevertheless, these lessons need to be learned again with each turn of the business cycle. Notwithstanding the result of pending appeals, lenders would do well to keep the following in mind:

- Be cautious of upstream guarantees, mortgages and other security interests and make sure that at least some value is given to the security-granting subsidiary entities.
- Conduct independent financial analysis of each individual debtor and subsidiary guarantor (rather than on a consolidated or "common enterprise" basis).
- Conduct careful due diligence and make sure you are aware of all market conditions and all public filings and notices relating to each debtor.
- Do not rely on savings clauses.
- Make sure solvency opinions are not contingency based and, if possible, make sure the underlying information used to make the determination of the opinion is independently obtained and examined. If, practically, a lender must rely on information provided by the debtor, the lender must question all assumptions made by the debtor and the validity of the information provided. Also, the lender must make sure it has the most up-to-date and accurate financial information available. <

SUBLEASING IN A DOWN ECONOMY, *CONTINUED FROM PAGE 8*

the premises if the master lease terminates. Often the landlord is only willing to "recognize" the subtenant in the event of a termination of the master lease if it is satisfied with the financial condition and creditworthiness of the subtenant, and if the subtenant commits to pay rent to the landlord at the rate set forth in the direct lease (which is often higher than the sublease rent) and be bound by all of the direct lease terms.

Because a sublease transaction involves three different parties—the landlord, tenant and subtenant—it can often have greater complexities than a direct lease, but it also provides opportunities for these parties to mitigate risk or obtain bargain terms, especially in a challenging commercial real estate market. <

Bingham's Real Estate Group Contacts

Practice Leaders

Frank A. Appicelli
Hartford
frank.appicelli@bingham.com
860.240.2984

Kenneth G. Lore
Washington, D.C., and New York
k.lore@bingham.com
202.373.6281 (DC), 212.705.7535 (NY)

Barry P. Rosenthal
Washington, D.C.
barry.rosenthal@bingham.com
202.373.6078

Richard A. Toelke
Boston
richard.toelke@bingham.com
617.951.8830

WASHINGTON, D.C.

Susan E. Duvall
susan.duvall@bingham.com
202.373.6686

Thomas Klanderman
thomas.klanderman@bingham.com
202.373.6074

J. Michael Pickett
michael.pickett@bingham.com
202.373.6071

Jeffrey S. Scharff
jeff.scharff@bingham.com
202.373.6622

David Tiger
david.tiger@bingham.com
202.373.6749

Erica H. Weiss
erica.weiss@bingham.com
202.373.6060

HARTFORD

Mark Oland
mark.oland@bingham.com
860.240.2929

R. Jeffrey Smith
jeff.smith@bingham.com
860.240.2759

BOSTON

James L. Black, Jr.
james.black@bingham.com
617.951.8754

Joanne D.C. Foley
joanne.foley@bingham.com
617.951.8892

Henry S. Healy
henry.healy@bingham.com
617.951.8271

Marcia C. Robinson
marcia.robinson@bingham.com
617.951.8535

Vincent M. Sacchetti
vincent.sacchetti@bingham.com
617.951.8563

Edward A. Saxe
edward.saxe@bingham.com
617.951.8723

Lawrence I. Silverstein
l.silverstein@bingham.com
617.951.8254

Maurice H. Sullivan III
skip.sullivan@bingham.com
617.951.8799

NEW YORK

J. Goodwin Bland
j.bland@bingham.com
212.705.7572

Richard S. Fries
richard.fries@bingham.com
212.705.7312

Martin I. Siroka
m.siroka@bingham.com
212.705.7503

Scott L. Stern
scott.stern@bingham.com
212.705.7315

SAN FRANCISCO

Edward S. Merrill
doc.merrill@bingham.com
415.393.2335

Mia Weber Tindle
mia.tindle@bingham.com
415.393.2540

SILICON VALLEY

Carol K. Dillon
carol.dillon@bingham.com
650.849.4812

Ellen E. Jamason
ellen.jamason@bingham.com
650.849.4826

Offices

Boston 617.951.8000	Hong Kong +852.3182.1700	Los Angeles 213.680.6400	Orange County 714.830.0600	Santa Monica 310.907.1000	Tokyo +81.3.6721.3111
Hartford 860.240.2700	London +44.207.661.5300	New York 212.705.7000	San Francisco 415.393.2000	Silicon Valley 650.849.4400	Washington, D.C. 202.373.6000

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