



# LENDING AND RESTRUCTURING ALERT

## SEPTEMBER 2008

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Every day, we field calls from our lending clients seeking Herrick's advice on how to deal with their defaulted loans. In this and future Lending & Restructuring Alerts, we address some of those questions, and share with you what we believe you should consider when facing similar situations.

### **Lender's Question**

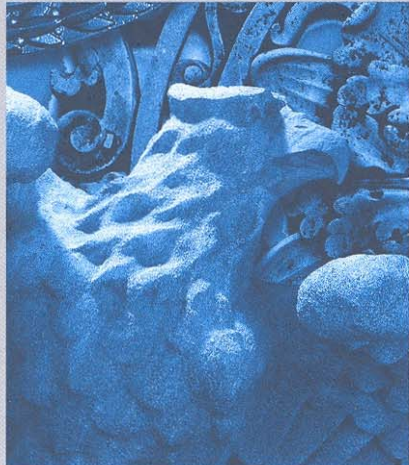
A little over a year ago, we extended a building loan to a borrower to construct a condominium in Brooklyn. While the loan is generally current, and the project is nearly complete, there are several non-monetary defaults under the loan agreement. Based upon those non-monetary defaults, do we have the right to decline to make an upcoming loan advance, accelerate the loan, and foreclose?

While modern loan documents provide extensive rights to lenders, a lender may want to think twice before exercising those rights based on technical interpretations where the default at issue does not involve a payment default. It may push your borrower into a corner, and you may find yourself facing a lender liability claim.

Lender liability claims are often frivolous and easily defeated. But they can cause headaches and unwanted delay in completing the foreclosure. Caution is warranted where building loan advances are at issue. A lender's refusal to make a building loan advance could trigger a chain reaction where the borrower fails to pay the general contractor, the contractor fails to pay the subcontractors, liens are filed, construction ceases, and sales are cancelled or lost. The borrower then defends against the mortgage foreclosure by asserting "lender liability" claims to the effect that the lender caused the very default at issue. Indeed, borrowers in these situations often claim that their lenders caused the failure of the development and should be held liable for damages.

### **An Example**

A well-known New York developer recently commenced a "lender liability" action against a major out-of-state lender in federal court. The plaintiff borrower asserted that the lender had improperly declared a default based on the borrower's failure to comply with a provision requiring the loan to be kept "in balance." Whether the loan was "in balance" was to be decided by the lender in its "reasonable" determination and "in good faith." The borrower alleged the loan at "default" was in the exact same "balance" as on the day it was made. The borrower alleged that the lender was having its own financial troubles and had asserted the "out of balance" default in bad faith to



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get out of the project. According to the borrower, the lender's actions jeopardized the project, including over \$100 million in contracts of sale. Consequently, the borrower and guarantors are seeking over \$250 million in damages from the lender (undoubtedly as part of a preemptive strike before foreclosure).

## Issues to Consider

Whether a lender should declare a default (and cease making advances) can depend on the seriousness of the non-monetary default at issue. For example, a borrower's failure to maintain insurance on the mortgaged property is certainly a very serious "non-monetary" default and courts have upheld default and acceleration where the borrower failed to maintain adequate insurance. Defaults involving the demolition, or improper alteration, of the mortgaged property are also serious enough to warrant declaration of a default. In contrast, a borrower's refusal to provide an estoppel certificate or a financial statement may be insufficient to warrant an acceleration unless there are also additional defaults of greater significance.

## Conclusion

Modern loan documents are lender-friendly and contain many provisions permitting the lender to declare a default, refuse to make loan advances, or to accelerate the loan and foreclose. In most instances, courts are likely, ultimately, to enforce those provisions. But why give borrowers—and their lawyers—the means to delay or hinder a loan enforcement action? Acceleration based on a clean payment default is almost always successful; why not wait until you have that in hand? It's almost sure to occur if the loan is truly troubled.

## What's your question?

Ask our experienced workout/foreclosure and restructuring team here at Herrick. Contact **Paul Rubin** at (212) 592-1448 or [prubin@herrick.com](mailto:prubin@herrick.com) or **Ray Hannigan** at (212) 592-1462 or [rhannigan@herrick.com](mailto:rhannigan@herrick.com).

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