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Shifting Tactics and Strategies for Lenders in Workouts



March 3, 2010

New York, New York



Enforcement of Non-Monetary Defaults

- Foreclosure is an equitable action
 - Equity vs. law
- Equitable actions are subject to equitable defenses
- Equitable defenses play a very limited role where the default is monetary
 - *Graf v. Hope Building Corp.* (N.Y.)
- Equitable defenses play a larger role when other forms of breach are involved



Enforcement of Non-Monetary Defaults (cont.)

- Non-monetary defaults generally enforced
 - Violation of due-on-sale clause
 - Acceleration permitted in a clear majority of cases
 - Purchaser's financial status is irrelevant
 - Breach of insurance obligation
 - Courts consistently enforce mortgage provisions permitting acceleration
 - Care must be taken to comply with any notice provisions

Enforcement of Non-Monetary Defaults (cont.)

- Non-monetary defaults generally *not* enforced
 - Tax defaults
 - Most courts deny foreclosure where the mortgagor ultimately pays any arrears
 - Notice provisions must be honored
 - Failure to repair
 - Borrower can generally avoid foreclosure by offering to make repairs
 - Minor defaults cannot serve as a basis for foreclosure



Enforcement of Non-Monetary Defaults (cont.)

- Alterations without consent
 - o Alterations would have to be very substantial and detrimental to serve as a basis for foreclosure
- Building violations
 - o Borrower will likely be allowed to correct any violations
- Mechanic's liens
 - o Validity of lien is important



Pre-Negotiation Agreements

- Typical terms
 - Settlement discussions not binding without writing
 - Participation in settlement discussions not a waiver
 - Release of claims
 - No reliance upon settlement discussions



Pre-Negotiation Agreements (cont.)

- Cases upholding pre-negotiation agreements
 - *23rd Street Development, LLC (N.Y.)*
 - *PBS Enterprizes (Wyo.)*
 - *Drofan Realty (N.Y.)*



Pre-Negotiation Agreements (cont.)

- Cases rejecting pre-negotiation agreements
 - *New Haven Two* (Conn.)
 - Lack of consideration
 - *Moosup Road* (Conn.)
 - Lack of mutuality



TOUSA Background

- TOUSA was a homebuilder “roll-up” play that served markets in the southeast and western sunbelt
- TOUSA grew rapidly from 1995-2006, taking on substantial debt to finance its growth



Transeastern Joint Venture

- In 2005, TOUSA formed a joint venture (“Transeastern”) to develop property in Florida
 - The joint venture borrowed \$675 million from a syndicate (the “Transeastern Lenders”), which was guaranteed by TOUSA
 - Transeastern was unsuccessful; the Transeastern Lenders declared a default in November 2006 and sued to collect
 - TOUSA settled litigation by agreeing to pay the Transeastern Lenders \$421 million



Transeastern Settlement

- TOUSA took out \$500 million in two Term Loans to finance settlement (the “July 31 Transaction”)
- Conveying Subsidiaries became co-borrowers, guaranteed the Term Loans and pledged their assets to secure their guarantees
 - At the time, TOUSA had over \$1 billion of bonds outstanding
 - Conveying Subsidiaries guaranteed the bonds



Fraudulent Conveyance Litigation

- The Creditors Committee sued
- Litigation sought to:
 - Void the Term Lender's liens
 - Void the guarantees issued by the Conveying Subsidiaries
 - Recover the payments made to the Transeastern Lenders



Rulings and Reasons

- Grant of liens was a fraudulent conveyance because the Conveying Subsidiaries:
 - Did not receive reasonably equivalent value in exchange for the guarantees and liens
 - Were insolvent *both before and after* the July 31 Transaction
 - Were unable to pay their debts as they became due because of the July 31 Transaction
 - Were left with unreasonably small capital with which to operate their businesses as a result of the July 31 Transaction



Rulings and Reasons (cont.)

- The Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the obligations and liens
- The Conveying Subsidiaries received no direct benefits
- The Conveying Subsidiaries received minimal, if any, indirect benefits



Rulings and Reasons (cont.)

- The July 31 Transaction did not indirectly benefit the Conveying Subsidiaries by keeping the parent out of bankruptcy
- The July 31 Transaction harmed the Conveying Subsidiaries because it saddled them with debt
- The Court found that the Committee satisfied its burden of proving insolvency



Rulings and Reasons (cont.)

- The Court discredited a solvency opinion prepared by experts on behalf of the Company at the time of the July 31 Transaction



Good Faith Defense

- Transeastern Lenders did not make adequate inquiry into solvency of TOUSA and the Conveying Subsidiaries
- Transeastern Lenders knew or should have known that TOUSA was insolvent by mid-2007



Remedies

- Court disallowed and avoided:
 - All obligations of the Conveying Subsidiaries to Term Lenders
 - All liens Conveying Subsidiaries granted to Term Lenders
- Disgorgement
 - All principal, interest and other fees
 - All fees paid by Debtors to Term Lender's professionals
- Transeastern Lenders required to:
 - Repay \$420 million in principal and interest
 - Disgorge payments to professionals



Savings Clauses Rejected

- The Conveying Subsidiaries were insolvent before and after the grant of the liens, so reducing the liabilities and liens against them would not make a difference
- Void as “ipso facto” provisions
- Improper attempt to contract around the fraudulent transfer provisions of the Bankruptcy Code



Savings Clauses Rejected (cont.)

- Unenforceable because it was impossible to determine the amount of the lien/liability reductions
- They modified the liabilities of the borrowers, but they were not signed by the parties



TOUSA Decision: Lessons

- Problem of upstream guarantees is not automatically solved by a solvency opinion and savings clauses
- A lender must take reasonable steps to investigate before engaging in transaction



TOUSA Decision: Lessons (cont.)

- Be careful about expert reports
- Ramifications of avoidance of refinancings that relied on upstream guarantees can be severe, so consider alternatives:
 - Limit the guarantees
 - Take pledge of stock in subs instead



Economic Duress

- *Pegasus Blue Star* case: highlights the law in the context of a loan origination but would apply to a workout/restructuring situation
- Lessons to Lenders:
 - Don't pull a "bait and switch" (beware the borrower's right to its "unfettered will")
 - Beware of providing any "assurances" during workout negotiations
- Does a PNA fully protect the lender?



Update on Destiny Case

- NYS Supreme Court issued mandatory injunction against the lender in 2009
- Affirmed on appeal; borrower to post undertaking
- Lessons learned:
 - Don't get "home-towned"
 - Read carefully the most basic terms of your loan documents
 - Populist anger may filter through to judges



Update on Foreclosures in New York

- What can receivers do?
 - They cannot sell condo units in New York
 - They can sign leases
 - They can complete construction



Tax Considerations in NY and NJ in Deed in Lien Transactions and Foreclosures

- New York State Real Estate Transfer Tax
- New York City RPT
- New Jersey Realty Transfer Tax and “Mansion Tax”
- Cancellation of Indebtedness Income Tax



Federal Income Tax on Foreclosure

- Generally, for federal income tax purposes, a deed in lieu of foreclosure and a foreclosure are treated in the same manner
- The federal income tax ramifications are dependent on:
 - whether the debt in question is recourse or non-recourse
 - the borrower's use of the property securing the debt



Non-Recourse Debt

- Treated as a sale by the borrower of the asset securing the loan
- Debt – adjusted tax basis = gain/loss
- Character of gain/loss depends upon the borrower's use of the property



Recourse Debt

- Two steps to determine tax liability
 - $\text{Debt} - \text{FMV} = \text{COD income (ordinary)}$
 - $\text{FMV} - \text{adjusted tax basis} = \text{gain/loss}$
- Character of gain/loss depends upon the borrower's use of the property



Exclusions to COD Income

- Bankruptcy – No COD to a taxpayer in a Title 11 case (flow through entities - applied at the member level)
- Insolvency - Exclusion limited to extent of insolvency (flow through entities - applied at the member level)
- Qualified Real Property Business Indebtedness
 - Debt must be secured by real property used in a trade or business of the debtor
 - Debt must have been incurred or assumed (including refinancing up to the original debt amount) to acquire, construct, reconstruct or substantially improve the property securing the debt and must be secured by real property used in a trade or business of the debtor
 - many limitations apply



COD Income Deferral

- Generally, COD incurred in 2010 can be deferred until 2014
- Taxpayer can take the income into account 20% per year over the five year period commencing in 2014



Modifications of Debt Instruments

- A significant modification of a debt instrument can be deemed a taxable exchange
- Generally, modifications that do not lower principal or reduce interest rates below the AFR may not cause an adverse tax consequence to either party



New York Transfer Tax Issues

Deed in Lieu

	Recourse Debt	Non-Recourse Debt
New York City (2.625%)	<ul style="list-style-type: none">• Outstanding debt and any unpaid accrued interest; plus• Liens and encumbrances remaining on the property after the transfer	Same as recourse



	Recourse Debt	Non-Recourse Debt
New York State (0.4%)	<ul style="list-style-type: none"> • the lower of: <ul style="list-style-type: none"> - outstanding debt and any unpaid accrued interest plus liens and encumbrances remaining on the property after the transfer; <u>or</u> - the property's FMV; plus • other costs of the property (such as unpaid water and sewer charges) 	<ul style="list-style-type: none"> • outstanding debt and any unpaid accrued interest; plus • liens and encumbrances remaining on the property after the transfer; plus • other costs of the property (such as unpaid water and sewer charges)



New York Transfer Tax

Mortgage Foreclosure

Lender Purchaser

	Non-Recourse Debt	Recourse Debt
New York City	<ul style="list-style-type: none">• Amount bid for property; plus• Liens and encumbrances remaining on property after the transfer	Same as non-recourse
New York State	<ul style="list-style-type: none">• The higher of:<ul style="list-style-type: none">- the bid price; or- the amount of the foreclosure judgment; plus• The amount of any continuing liens on the property	Tax is imposed upon FMV of the property at the date of the conveyance



New York Transfer Tax

Mortgage Foreclosure

Unrelated Purchaser

	Recourse	Non-recourse
New York City	Same as non-recourse lender purchaser	Same as non-recourse lender purchaser
New York State	<ul style="list-style-type: none">• Bid price; plus• Liens and encumbrances remaining on the property after the transfer	<ul style="list-style-type: none">• Bid price; plus• Liens and encumbrances remaining on the property after the transfer



New York Transfer Tax

Mortgage Foreclosure

Related Party Purchaser

New York City	Same as non-recourse lender purchaser
New York State	<ul style="list-style-type: none">• Purchase is bifurcated and treated as if two pieces of property have been purchased, subject to the rules mentioned above• The lender or related party and the unrelated person are treated as having purchased the two properties in proportion to their respective ownership of the acquisition vehicle



New York Transfer Tax

UCC (Mezz Debt) Foreclosure

New York City	<ul style="list-style-type: none">• Bid price; plus• Senior liens not cancelled by the sale, plus advertising expenses, taxes and other costs paid by the purchaser (whether purchaser is related or unrelated)
New York State	<ul style="list-style-type: none">• Lower of:<ul style="list-style-type: none">- FMV of property; and- (1) amount of mezz debt being foreclosed upon; plus<ul style="list-style-type: none">(2) debts, liens and encumbrances remaining on the mezz entities and/or property after transfer; and(3) any other amount paid by the lender for the conveyance
	<p>Note that if the mezz entity has other assets in addition to real property, the transfer tax liability may be imposed upon the allocable portion of its assets represented by real property</p>



New Jersey Realty Transfer Fee

Deed-in-Lieu and Mortgage Foreclosures

- Rate up to about 2.2% in total
- Generally, New Jersey imposes the realty transfer fee on deed transfers including deed-in-lieu and mortgage foreclosures
- The tax is imposed upon:
 - Any amount paid for the transfer; plus
 - The remaining amount of any prior mortgages to which the transfer is subject or which is assumed; plus
 - Any other lien or encumbrance satisfied or removed in connection with transfer of title



New Jersey Realty Transfer Fee

Mezz Foreclosures

- NJ does not impose the realty transfer fee on transfers of ownership interests in entities owning real property
- However, NJ imposes the “controlling interest transfer tax” on non-deed transfers
- A 1% fee is imposed on the sale, for consideration in excess of \$1 million of a controlling interest in an entity which possesses, directly or indirectly, a controlling interest in “classified” real property (payable by the purchaser)
- Classified real property includes any real property that is income-producing other than property classified as vacant land, residential property, farm property, industrial properties, and apartments



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