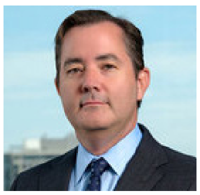
Commercial Foreclosure Alternatives (VA)

A Practical Guidance® Practice Note by John G. Kelly, Bean Kinney & Korman



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Once a commercial real estate mortgage loan is in default, foreclosure or bankruptcy are not the only possible alternatives. This practice note discusses alternatives to foreclosure for a commercial real estate loan in Virginia once an event of default is accepted and not in dispute, with a special focus on the deed in lieu process. The note also addresses loan restructures and forbearance agreements as possible foreclosure alternatives and includes brief overviews of tax and bankruptcy-related issues. Every commercial mortgage in default contains particular facts and concerns that need to be carefully analyzed before the lender and borrower can agree on the correct solution, and some of the possibilities discussed in this note may not be a suitable choice in a particular matter.

For guidance on commercial foreclosures in Virginia, see Commercial Foreclosure (VA). For guidance on commercial real estate lending in Virginia, see Commercial Real Estate Financing (VA).

Overview and Preliminary Considerations

Once a lender in Virginia commits to moving forward in enforcing its remedies after an event of default (instead of waiving the default), there are alternatives to moving immediately to a foreclosure. This practice note assumes that both the lender and the borrower have performed all due diligence and accepted the validity of an event of default under the loan documents and that no realistic defenses by borrower or great risk of lender liability are present. By the time a workout is considered, lender's counsel should have reviewed all loan documents as well as the borrower's organizational documents and ordered updated title and lien searches. If a deed in lieu is a possible solution, the lender should also obtain an appraisal of the collateral property. Both the borrower and the lender need to evaluate the loan in light of current market conditions.

No matter which alternative to foreclosure is selected, lender's counsel should ensure that the documentation requires the borrower and any guarantors to affirm the obligations under the original loan documents and agree upon the enforceability of these documents. In addition, lender's counsel should include provisions where the borrower and any guarantors waive all claims against the lender and any defenses to enforcement under the loan documents.

Forbearance Agreement

Under a forbearance agreement, also known as a standstill agreement, the lender chooses to not enforce its remedies under the loan documents for a set period of time in exchange for the borrower agreeing to take specific actions. The forbearance agreement helps the borrower by giving them additional time to solve the issues that led to the loan default. For example, the borrower might use the forbearance period to attempt to sell the property or find other investors, or to sign up new tenants for the project to improve its cash flow and value. For the lender, the forbearance agreement may include concessions from the borrower, such as obtaining additional collateral or guaranties, adding new financial covenants, or gaining more control over the property. If the borrower has little left to offer the lender in terms of additional security, the lender can push for a forbearance fee as consideration for delaying their enforcement. If nothing else, the forbearance agreement will likely contain the typical waivers and releases that should put the lender in a better position in the event the parties eventually end up in a contested battle.

The forbearance agreement is not a formal long-term modification restructure of the loan, but likely will still contain provisions that waive certain defaults and modifies certain of the borrower's obligations such as payment schedules and the maturity date.

For a sample form of forbearance agreement, see Forbearance Agreement (Commercial Real Estate Loan).

Loan Restructure

Even though the borrower may be under a clear event of default, and the lender is not interested in simply waiving the default, certain factors could lead the lender to remain confident in the borrower's longer-term position and decide that a loan restructure is a better alternative than acquiring the collateral through a foreclosure or a deed in lieu transaction. For example, the 2020 COVID-19 pandemic has disproportionally affected owners of certain types of commercial real estate such as hotels. The lender may decide that restructuring the loan is the best long-term option as it preserves the relationship with the borrower and avoids the considerable expense and delays associated with contested litigation or bankruptcy.

A restructure is a form of loan workout that amends the terms of the loan. In such a transaction, the lender modifies the loan to offer the borrower concessions on key economic terms such as payment obligations or maturity dates, and in exchange, the borrower offers the lender something of value. Both the lender and the borrower are operating under the good faith expectation that the amended loan will result in the lender being repaid in full under the amended loan documents.

The restructure can contain a variety of loan modifications, but some of the most common amendments are listed below.

Loan amendments that benefit the lender include:

- An equity pledge from the borrower
- Additional collateral pledged by the borrower
- Modification of the recourse liability provisions in the loan documents
- Payment of a modification fee from the borrower to the lender
- Future automatic adjustment of loan terms if certain conditions are not met, such as increasing the interest rate or accelerating the maturity date
- A partial paydown of the principal balance of the loan

Loan amendments that benefit the borrower include:

- Extension of the maturity date
- Reduction of the interest rate
- Deferment of loan payments to a later date

As part of the documentation for the loan restructure, the lender should include provisions that protect it if the borrower later declares bankruptcy and that smooth the way to a future possible foreclosure. Lender's counsel should use similar releases and estoppels as found in the forbearance agreement mentioned above. However, lender's counsel working on Virginia transactions should be cautious before requesting a "deed in escrow," where the lender request that the borrower execute and deliver a deed to the collateral property that the lender holds pending a later material default by the borrower. If contested down the road, Virginia courts will carefully review the intent of the parties to determine whether the deed was given for good and adequate consideration and if a conveyance does not clog the borrower's equitable right of redemption. Language establishing these factors must be carefully drafted. As always, individual facts in each transaction should be paramount.

Deed In Lieu of Foreclosure

After conducting its distressed loan due diligence, the lender may determine that none of the workout possibilities discussed above are in its best interest. Restructuring the loan may be impractical given that economic circumstances make foreclosure inevitable, but the lender may want to avoid the expense and time needed to foreclose. If the value of the collateral property is less than the balance of the loan, both parties may determine that a deed in lieu is the best way for the lender to acquire title to the real estate that serves as collateral of the loan. A deed in lieu of foreclosure is the compromise position where the borrower avoids foreclosure by giving the lender title to the property in exchange for cancellation of the indebtedness. The main advantage offered to both borrowers and lenders is that a deed in lieu avoids the cost, time, and negative stigma of a drawn-out and contested foreclosure action. Lenders can quickly and efficiently take over the operation of the project and preserve existing leases and contracts while borrowers can obtain a release of their personal liability.

Initial Steps and Considerations

Before moving forward with a deed in lieu transaction, lender's counsel should review the loan documents, the organizational documents of the borrower and the loan file to confirm the current ownership status of the borrower entity, and the consents required from the borrower to authorize the delivery of the deed in lieu.

To preserve the validity of the transfer of the property to the lender, the conveyance must be voluntarily given and for adequate consideration. This is necessary to protect the lender from the borrower, in an effort to overturn the transaction, later arguing that they were subject to duress, undue pressure, or fraud. With regard to adequate consideration, the lender typically will not accept the conveyance unless the fair market value of the property is close to the amount of the indebtedness. In other words, the property can be acquired for less than the total cost of a foreclosure. To make clear the transfer was voluntary, the borrower should first submit a written offer to the lender offering to convey the property to the lender by outlining the terms and conditions of the offer. The lender should in turn reply to the borrower's offer in writing, providing a list of conditions under which it will accept a deed in lieu. With respect to the adequacy of the consideration, the lender and borrower should self-servingly provide in an agreement that the current value of the property is equal to or less than the outstanding indebtedness. Lastly, as part of its due diligence, the lender should order an appraisal of the property, along with a title search and environmental study.

The deed in lieu agreement should not contain any rights or options for the borrower to repurchase the property. And if the parties agree that the borrower can manage the property post-conveyance to provide cash flow to the borrower and a smooth transition for the lender, the management needs to be very limited with no ownership authority. To avoid any potential claims later that the transaction constitutes an equitable mortgage instead of a transfer, the language in the transaction documents must make it very clear that the deed is an absolute conveyance.

Usually, the agreement also preserves the lender's first lien on the property. This gives the lender the right to later proceed with a regular foreclosure to wipe out any junior lienholders and clear title as needed. To preserve this right, the agreement should make clear the intent of the parties, by including non-merger language, for the lien to remain even though the lender would then be the owner of the property as well as the holder of the mortgage lien. Another method of dealing with these anti-merger concerns is to have the lender take title to the property in a related entity.

The doctrine of merger is one of the biggest concerns for the lender, and also the title insurance company, because if the deed of trust lien is deemed extinguished, the lender can no longer wipe out junior liens and encumbrances through a subsequent foreclosure. Anti-merger language in the deed in lieu agreement and the conveyance deed should make the intent of the parties absolutely clear to survive any later challenge from junior lienholders.

Advantages and Disadvantages

A fully nonrecourse loan makes the decision to move forward with a deed in lieu easier on both the borrower and the lender, but if the loan is recourse or subject to carve-outs, the lender needs to carefully review the proposed structure based on its review of market conditions and the borrower's financials. Since both the lender and the borrower need to agree that the deed in lieu process is better than a foreclosure, some of the main advantages and disadvantages for both parties are listed below.

Advantages for the borrower include the following:

- The borrower avoids the negatives consequences of a foreclosure, including adverse publicity, reputational harm, and the need to report a prior foreclosure on future loan applications. In addition to preserving its reputation and credit, the borrower avoids burning bridges with the lender.
- Typically, the main benefit to the borrower, if the loan is not fully nonrecourse, is the release of recourse and/or guarantor liability. The release can be a full release or a partial release with certain obligations (such as recourse carve-outs or environmental indemnities) surviving.
- Since the borrower and the lender are working together in a process that hopefully benefits both parties, in addition to possibly preserving the business relationship so the parties can work together on future deals, the borrower may be able to continue working on the current project. For example, depending on the type of commercial property, the lender may keep the borrower's affiliate on board for leasing or management services if the project is unique and the borrower has the most institutional knowledge.

Advantages for the lender include the following:

- For the lender, a deed in lieu transaction is much faster and typically much less expensive than a full foreclosure.

Because nonjudicial foreclosure is permitted in Virginia, the state is not known for having overly long commercial foreclosures, but they still take much longer than a voluntary conveyance.

- The lender acquires immediate control of the project in a faster process than a foreclosure. In many circumstances, the lender is concerned about physical or economic waste or damage to the project, and the faster the lender can obtain the control, the better its changes of salvaging the collateral. If the collateral would fall into disrepair, the value could drop even lower and make the property harder for the lender to subsequently sell to a third party.
- For commercial properties that are income-producing, a deed in lieu does not involve the tenants.
- Similar to the advantages to the borrower, the deed in lieu process avoids the negative reputational consequences of a foreclosure and preserves the relationship between the developer borrower and the institutional lender to work together on future deals.

Disadvantages for both parties:

- In a deed in lieu transaction, unlike a foreclosure, junior liens and encumbrance are not wiped out. However, as discussed in this practice note, the lender should be able to structure the transaction in a way to preserve its right to subsequently foreclose.
- If the deed in lieu is not documented properly, there is a possibility that the mortgage interest and the fee interest in the collateral property merge. If so, the lender would be unable to foreclose later on the senior lien and wipe out junior liens and encumbrances.
- As discussed below, there are risks that the transfer may be set aside if the borrower later declares bankruptcy. Lender's counsel can better protect its client by documenting the transaction as recommended in this practice note.
- In Virginia, the deed in lieu is not exempt from transfer taxes. Who pays these and other expenses such as title insurance premiums are subject to negotiation between the parties.
- If a transaction involved a mezzanine lender, the parties likely entered into an intercreditor agreement that prohibits the senior lender from accepting the deed in lieu without providing notice and likely an opportunity to cure the borrower's defaults to the mezzanine lender. Therefore, the senior lender needs to adhere to these requirements, which can present an added layer of complexity to the process. However, in some cases, the mezzanine lender may decide that it is in its best interest to attempt to acquire the senior loan, which could be an attractive scenario for the senior lender.
- The lender, and the title insurance company, will be concerned that the transaction might be recharacterized as an equitable mortgage or that the borrower can later argue that the lender clogged its statutory and/or equitable rights to redeem the property prior to foreclosure.

Documentation

It is imperative that lender's counsel properly document a deed in lieu transaction. Proper documentation protects the lender if the borrower later files for bankruptcy and preserves the lender's right to later foreclosure to wipe out any other encumbrances. Documents you will likely need in any deed in lieu transaction include the following:

- A deed in lieu agreement that describes the overall transaction, attaches the other documents as exhibits, and sets forth the clear intent of the parties. For a sample form, see Deed in Lieu of Foreclosure Agreement (Commercial) (Pro-Lender).
- A deed with non-merger language providing that the lien of the deed of trust is not extinguished. For guidance on drafting a deed in lieu in Virginia, see Virginia Forms No. 16-585.
- A release form in which the borrower releases the lender and its affiliates from any claims and potential liability in connection with the collateral property and loan documents. In Virginia, the release language is often incorporated into the deed in lieu agreement and/or drafted as a stand-alone document. For a sample form, see Release (Deed in Lieu of Foreclosure).
- An owner's affidavit will be required by the title insurance company that issues a new owner's title policy to the lender. For a sample form, see Owner's Affidavit (Deed in Lieu of Foreclosure) (Commercial), but note that individual title insurance companies may require that parties use their form.
- A covenant not to sue, in which the lender agrees not to seek a deficiency judgment against the borrower and to instead accept title to the collateral property as full satisfaction of the loan. This is often required by the borrower's counsel. For a sample form, see Covenant Not to Sue (Deed in Lieu of Foreclosure) (Commercial).

Title Insurance Issues for a Deed In Lieu Transaction

The lender should work with an experienced and sophisticated title insurance company on a deed in lieu transaction. Since most lenders will not cancel the promissory note and therefore keep the lien of the deed of trust to preserve its right to foreclose on the lien at some later time, the lender can rely on its existing lender's policy of title insurance. However, the loan policy only deals with matters of record in existence at closing of the loan and does not give the lender protection regarding the enforceability of the deed in lieu conveyance or offer protection for subsequent matters of record. For these and other reasons, lender's counsel should instead obtain a new owner's policy of title insurance, which offers greater protection for the lender.

Title insurers will want to conduct their own due diligence before agreeing to issue a new owner's policy. Their concerns are similar to that of the lender, such as later bankruptcy issues and borrower arguments attempting to void the conveyance. The title company needs to review all agreements entered into between the parties and typically requires that:

- No agreement between lender and borrower contains any right, option, or obligation of the borrower to redeem, reacquire, or repurchase the property
- No agreement allows the borrower or any other party to rescind the transaction
- The borrower and all guarantors will be released from personal liability on the underlying debt –and–
- The borrower must vacate the property and surrender possession to the lender

Since the creditors' rights endorsement is no longer available, borrower's counsel in Virginia does not have as many choices in obtaining owner's coverage. The title insurer will likely keep the deed of trust as an exception on the policy since the lender typically does not release it of record. The borrower's counsel should ask if the title company will provide a non-merger endorsement, but those are typically not available.

Bankruptcy Issues

In certain circumstances, if the borrower later files for bankruptcy, a conveyance of the property back to the lender could be disallowed. The two main issues to be concerned about with respect to bankruptcy after a deed in lieu are preferential transfers and fraudulent conveyances and are outlined below. However, this practice note does not review all ramifications of a subsequent bankruptcy by the borrower, and bankruptcy counsel should be consulted before moving forward with any alternative to a commercial real estate foreclosure. For further guidance, see Fraudulent Conveyances versus Preference Actions.

Section 548 of the Bankruptcy Code provides that fraudulent conveyances may be set aside if made within the statutorily proscribed time frames. To be deemed fraudulent, a transfer must be made for less than the reasonable equivalent value and the borrower must meet certain tests of insolvency. That is, collateral transferred by the borrower to the lender may be voided by the bankruptcy trustee as a fraudulent transfer if (1) the borrower received less than reasonably equivalent value for the transfer and (2) at the time of the transfer, the borrower was insolvent, rendered insolvent, or inadequately capitalized. The lookback period for fraudulent transfer claims under the Federal Bankruptcy Code is two years prior to the subsequent bankruptcy of the borrower, but in specific circumstances, state law can extend the period. If counsel for the lender, you need to explain to your client the rules regarding fraudulent conveyances and take all steps necessary to establish that reasonable equivalent value was given.

Under Section 547 of the Bankruptcy Code, preferential transfers within 90 days of the date of bankruptcy filing may be set aside. Further, preferential transfers from insiders who had reasonable cause to believe the debtor was insolvent may be set aside if it is made between 90 days and one year prior to the date of filing of the bankruptcy petition. A preferential transfer is a transfer from an insolvent debtor that is made for the benefit of a creditor and results in the creditor receiving more than it would have received in a Chapter 7 liquidation if the transfer had not been made. If a transfer is deemed a preference, the bankruptcy trustee can avoid it and recover the funds or the property and use it to pay the claims of other creditors. To prevent the transfer from being voided by the bankruptcy trustee, the lender must show that the lender did not receive more than it would have been entitled to under a Chapter 7 liquidation because the fair market value of the property conveyed is less than the outstanding indebtedness owed to the lender.

As counsel for the lender, it is important to include the waivers and stipulations discussed above in the workout documents so as to lessen the risk that these claims may be raised in a subsequent bankruptcy by the borrower. If the lender is properly prepared for bankruptcy by the borrower, they should not fear this common outcome.

Tax Issues

It is important to consult with tax counsel and accountants so both the lender and the borrower can better understand any tax consequences of pursuing an alternative to a commercial real estate foreclosure. For example, a borrower considering the possibility of foreclosure or a deed in lieu of foreclosure should be aware that these events can lead to income taxation of capital gain or cancellation of indebtedness income. For other alternatives to a commercial real estate foreclosure such as a typical loan workout, if a loan modification is deemed a "significant modification of a debt instrument," the borrower may have cancellation of indebtedness income even if the principal amount of the loan is not actually reduced. In this circumstance, the lender also has reporting obligations.

The tax results depend in large part on whether the loan is a recourse loan or a nonrecourse loan. A nonrecourse loan is one where the lender's sole option for recovering on the loan is to take back the property. If the lender can pursue the borrower personally for any shortfall by obtaining a deficiency judgment, then it is a recourse loan.

In the case of a nonrecourse loan, the conveyance is taxed as if it were sold for the greater of the outstanding debt or the sales price. The nature of the gain and the deductibility of any loss depends on the holding period and the nature of the property.

In the case of a recourse loan, in addition to the potential income and gain resulting from the sale for value, there also may be cancellation of indebtedness income if the debt exceeds the value of the property. Cancellation of indebtedness income is taxed at ordinary income rates, but there are several temporary exceptions. For example, you can exclude cancellation of indebtedness income if the debt is discharged in bankruptcy, to the extent the borrower is insolvent, or in certain situations related to qualified real property business indebtedness. Note that the exception for real property business indebtedness is generally available for rental real estate and other income-producing property, but typically is not available for property held for sale such as a residential development.

Tax issues are not limited to the borrower. Lenders also need to carefully understand the tax issues in each alternative to a foreclosure. A modification of a commercial real estate loan that reduces the principal balance of the loan in some circumstances may be considered taxable gain for the lender if the lender's tax basis in the loan is less than the new principal balance.

This practice note only touches on tax issues generally. For a more detailed analysis of tax issues, see Federal Taxes Affecting Real Estate §§ 12.09, 12.10.

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John G. Kelly is a shareholder of Bean, Kinney & Korman and focuses his practice on general corporate law and real property law, including commercial real estate leasing, financing and acquisitions, and business mergers and acquisitions.

With respect to leasing, John represents both landlords and tenants nationwide in substantial office, retail, industrial and government leasing transactions. John serves on the Board of Editors of Commercial Leasing Law & Strategy, a national publication. He has also served as a featured guest on real estate leasing topics on Commercial Real Estate Radio.

His lending experience includes representing both lenders and borrowers in complex financial transactions secured by real or personal property, including the negotiation of the initial loan documents and advising with respect to workout strategies and foreclosures.

John represents sellers, lenders and developers in connection with real estate investments throughout Virginia and Maryland. These transactions involve the construction and development of office buildings, shopping centers, hotels and other investment-grade properties, including negotiating agreements and the review of due diligence on behalf of both lenders and purchasers.

John's sales and acquisition experience includes the representation of sellers and purchasers of large office properties, hotels and undeveloped land throughout Virginia, Maryland and Washington, D.C.