

NOTE FROM THE REAL ESTATE RESTRUCTURING GROUP

ACQUISITION OF DISTRESSED MORTGAGE DEBT: BEWARE OF THE QUALITY OF THE MORTGAGE LIEN

Given the deterioration in the commercial real estate market, it has become apparent to many sophisticated real estate investors that the acquisition of non-performing mortgage debt securing real estate assets may offer a more attractive investment opportunity than the direct acquisition of real estate or equity interests (and, in many cases, it may be the only means available to acquire the real estate).

As is the case with any purchaser of real estate assets, the purchaser of non-performing mortgage debt will need to assess the property related fundamentals of the real estate and related risks as part of its underwriting, such as local market conditions, leasing status, property and environmental conditions, and title and zoning. (In the context of acquiring non-performing debt, it should be noted that an accurate and complete due diligence review of many of these property related fundamentals, and certainly desired representations and estoppels with respect to these fundamentals, may not be obtainable since the borrower's cooperation will not be present). However, in the context of purchasing non-performing mortgage debt, the additional need to assess the quality of the mortgage lien itself is very often underappreciated in connection with underwriting the investment opportunity.

First and foremost, and even in the most intricate and complex debt structures, at the end of the day, the purchaser of mortgage debt must recognize that it is purchasing a claim and a potential litigation. The purchaser's ability to succeed in enforcing its claim, and to prevail in such litigation, in a timely and cost efficient manner and without exposure to liability, will be determined to a significant extent by the "quality of the mortgage lien." Whether the ultimate goal of the purchaser (or following the acquisition of the mortgage, the final exit decision) is to foreclose upon the real estate, sell the mortgage loan or settle with the borrower (i.e., by a loan workout or deed in lieu transaction), the quality of the mortgage lien and the ability to enforce the mortgage through a foreclosure are paramount concerns for any purchaser or holder of mortgage debt.

In general, the "quality of the mortgage lien" will be determined by the following factors: (i) the ability to verify the amount of the indebtedness secured under the mortgage, including the outstanding principal balance, interest accrued at the stated and default rates, late charges and other sums, (ii) the lien priority of the mortgage and what encumbrances have seniority over the mortgage, (iii) whether the provisions in the mortgage documents are clearly enforceable and allow for an unimpeded foreclosure on the real estate assets, (iv) if applicable, whether proper notice of default has been given and the quality of the litigation documents (e.g., have all proper parties to the foreclosure action been named and served, and are the

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required allegations present in the complaint), and (v) the risk of borrower's defenses and counterclaims (whether arising out of the lender's breach or course of dealings).¹

Having litigated hundreds of commercial real estate foreclosure actions in both State and Federal Court, on behalf of nationally and regionally recognized banks and real estate equity funds, as well as Freddie Mac and the Resolution Trust Corporation, Tannenbaum Helpert has considerable insight into assessing the quality of the mortgage lien that a purchaser of mortgage debt will acquire and, accordingly, the ability to enforce the mortgage debt and realize on its investment.

The following are a few interesting examples of deficiencies that were present in the "quality of the mortgage lien" which, much to the dismay of the mortgage holder, surfaced in connection with the foreclosure of the applicable mortgage. Of course, the purchaser of non-performing debt will want to be aware of any existing deficiencies in the quality of the mortgage lien in an effort to reduce the risk of unforeseen costs, delays and liabilities.

Course of Dealings/Oral Modification

The purchaser could be subject to the borrower's claim that the prior mortgage holder, through its course of dealings, waived obligations of the borrower or agreed to modifications to the terms of the mortgage loan. In the one case (Suffolk County Nat'l Bank v. Columbia Telecommunications Group, Inc., 38 A.D.3d 644, 832 N.Y.S.2d 80 (2d Dept 2007)), the Court denied the mortgage holder's motion for summary judgment for foreclosure, finding that the borrower had presented evidence raising an issue of fact as to whether the parties had entered into an enforceable oral agreement to restructure the mortgage debt. The Court reached such holding notwithstanding that the parties had entered into a pre-negotiation agreement expressly providing that only written modifications of the mortgage documents would be enforceable. In this instance, the Court was persuaded by evidence that representatives of the mortgage holder had met with the borrower after the borrower filed bankruptcy proceedings and agreed to terms for a complete restructuring of the indebtedness. Although no written agreement was finalized, the borrower alleged that it dismissed its bankruptcy filing based on the oral agreement.

In another case, Fairchild v. United Bank of Kuwait, 285 A.D.2d 444, 727 N.Y.S.2d 153 (2d Dept 2001), the borrower submitted partial payments of monthly debt service to the lender during consecutive months, which were deposited by the lender. Subsequently in the foreclosure case, the borrower argued that the lender agreed to modify the loan agreement by transforming the loan into a cash-flow mortgage, and that the modification was evidenced by the cessation of full monthly payments, the establishment of a segregated account whereby rental revenue was designated for tenant improvements, and by the lender's failure to accelerate the loan for seventeen months after cessation of payments in full. The lender contended that the delay in acceleration was due to efforts to negotiate a loan workout. Notwithstanding the fact that the loan documents expressly provided that oral modifications should not be enforceable, the Court held that the borrower raised a triable issue of fact by submitting evidence showing partial performance of the alleged loan modification.

Default Notice Failure

The purchaser, acquiring a non-performing loan under the assumption that a default has been properly declared by the prior mortgage holder, could subsequently discover that proper notice of default was not given under the mortgage documents. In Norwest Bank Minnesota v. Sabloff, 297 A.D.2d 722, 747 N.Y.S.2d 559 (2d Dept 2002), the Court denied the lender's summary judgment motion for foreclosure and, in effect, requiring that the action be recommenced, where the only evidence the lender had to prove

¹ For the purposes of this article, we have not considered co-lender and intercreditor agreement issues, or bankruptcy concerns, which may also be material considerations in purchasing mortgage debt, where applicable to the transaction.

that a proper default notice was delivered under the mortgage documents was an affirmation of its attorney.

Break In The Mortgage Assignment Chain

With the exponential growth of the commercial mortgage securitization market over the last fifteen years (until the market came to a sudden halt in the summer of 2008), mortgages were often sold and transferred in many instances without recording an accurate assignment to the intended assignee of the mortgage. Often the problems raised by a defective assignment or missing assignment are fixable, although curing the problem can sometimes consume considerable time. However, in certain instances, the failure to have a mortgage properly assigned can become a complete bar to a foreclosure action. In Colony Mort. Bankers v. Levell, 194 Misc.2d 447, 753 N.Y.S.2d 820 (Sup. Ct. 2003), the assignee of the mortgage commenced a foreclosure action in the name of the previous mortgage holder. (Why the action was commenced in the name of the previous mortgage holder is not clear.) The defaulting borrower moved to dismiss the action on the ground that the plaintiff had sold the mortgage and therefore had no standing to bring the action. The mortgage holder, relying on well-recognized practice and regulations, moved to amend the complaint to correct the issue so that the foreclosure case would now proceed in the name of the actual mortgage holder. The Court dismissed the action, noting that it would not allow the complaint to be corrected to allow a non-party to step into the shoes of the plaintiff. To be sure, the mortgage purchaser could subsequently bring the foreclosure action anew in the correct name, but the additional costs incurred in having the first action dismissed and the many months of delay was significant.

In another recent case, Wells Fargo Bank N.A. v. Reyes, 1/15/2008 N.Y.L.J. 27 (Col. 3), the Court held the plaintiff lacked standing to prosecute the mortgage foreclosure because the mortgage assignment to the plaintiff was not evidenced as being recorded in the Office of the City Register, and the Court dismissed the complaint and cancelled the mortgage holder's notice of pendency. In this instance, the Court further held the plaintiff's action to foreclose on a mortgage it did not own may constitute a "frivolous motion," potentially subjecting plaintiff's counsel to sanctions.

Litigation Delay

In the course of a foreclosure action, many delays will occur and perhaps are inevitable (i.e., settlement negotiations, busy court schedules, etc.). However, a substantial delay arising solely from the inaction of the mortgage holder can result in adverse consequences to the mortgage holder. In Danielowich v. PBL Development, 292 A.D.2d 414, 739 N.Y.S.2d 408 (2d Dept 2002), the mortgage holder delayed in pursuing the next step in the foreclosure action for five months after obtaining the referee's computation of the sum (that next step being applying for a judgment and confirmation of the referee's report). The Court accepted the borrower's objection to the application of default interest (16% per annum) during the delay period and instead applied a 9% per annum judgment rate on the outstanding balance during such delay period. This case serves as a reminder that a foreclosure action in New York is an action in equity and the Courts will generally consider the borrower's claim that a significant delay by the mortgage holder in pursuing the foreclosure action has caused an unfair or inequitable impact on the borrower.

In acquiring non-performing mortgage debt, the risk of litigation (and the related cost, time and liability exposure) often goes hand-in-hand with the availability of the distressed investment opportunity. Although, more often than not, the failure of the purchaser of mortgage debt and its counsel to fully comprehend the deficiencies in the quality of the mortgage lien will not bar the purchaser from ultimately completing the foreclosure action, such deficiencies may cause the purchaser to incur significant and unforeseen legal fees and other costs, delays in the completion of the foreclosure, and exposure to liability. Only with a comprehensive review of the quality of the mortgage lien, with the assistance of experienced legal counsel, may a sophisticated purchaser make a fully-informed evaluation of the risk and reward of the investment opportunity.

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The Real Estate Restructuring Group is comprised of attorneys from several of Tannenbaum Helpert's practice areas, and provides a cohesive, multi-disciplinary, legal team, with a targeted focus on providing strategic advice and effective solutions to the diverse and complex issues which must be addressed in connection with the acquisition, restructuring and disposition of distressed real estate assets. If you have any questions regarding this Note, or the Real Estate Restructuring Group, please contact Eric S. Schoenfeld (212.508.6713 or schoenfeld@thshlaw.com) or David A. Pellegrino (212.508.6716 or pellegrino@thshlaw.com), or any of our firm's partners. You may also visit our firm's website: www.thshlaw.com.