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Distressed Owner Transactions: Common Questions

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THERE ARE ALL SORTS of questions and problems that often arise in connection with sales or mortgage restructurings or refinances in the midst of an economic downturn such as the one we are experiencing today. Some of those were addressed in my article earlier this year ("Distressed Owner Transactions: Common Questions," New York Law Journal, special Real Estate & Title Insurance Trends pullout section, at S2).

Secure in the knowledge that the only foolish question really is one that is not asked, I would like to take this opportunity to discuss some additional questions and problems that arise often in this context. They are set forth below, again in a question and answer format.

1. Client is the holder of a building loan mortgage on a piece of real property located in New York. Approximately 65 percent of the loan has been advanced to date, and work is ongoing on the site. The project, however, is over budget and behind schedule. The client and the property owner are entering into an agreement that requires the owner to put additional funds into the project and that extends the time period to complete. Do I need to amend the existing building loan agreement in connection with this agreement? If not, when would I?

Notwithstanding the language in New York Lien Law §22 that "…any modification (of a building loan contract)…must be in writing and…any subsequent modification of any such building loan contract so filed must be filed within ten days of execution," it is not every modification of a building loan agreement that must be filed.[1] Only those modifications that are "material" must be filed in accordance with §22.[2]

A "material modification" is not limited only to those modifications that result in a change to the net sum available;[3] it is one that alters the rights and liabilities otherwise existing between the parties to the agreement or enlarges, restricts or impairs the rights of any third party beneficiary,[4] or one where an essential term of the building loan contract is changed, such as the amount or the manner of payment.[5]

Among the kinds of modifications that have been deemed material are: the waiver (by failure to enforce) of a building loan contract provision requiring borrower to obtain a payment bond as a condition to the advance of loan proceeds;[6] the amendment of a provision of the building loan agreement authorizing the conversion of the property to condominium;[7] and the amendment of a provision of a building loan agreement that requires that other sums or sources be made available for payment of contractors or suppliers aside from the loan proceeds.[8]

By contrast, the waiver of a building loan contract provision calling for borrower to obtain a payment bond that could, in the discretion of the lender, be required;[9] a straight extension of time that left the parties with the same rights and liabilities;[10] and the waiver of the right to hold borrower in default even though the building loan agreement would allow the lender to do so,[11] are all examples of modifications that were determined to be non-material which, accordingly, did not require the filing of a modification.

2. Client is the holder of a mortgage on real property located in New York state. The loan is presently in default, and the owner and mortgagee are negotiating an agreement that restructures the loan. Included in this negotiation is a discussion regarding a procedure whereby the property owner will execute a deed and transfer tax forms in blank. These documents are to be placed in escrow with the mortgagee, with the agreement that the documents will be released from escrow, completed and recorded in the event of a further default by the owner. What are the pitfalls, if any, of such an arrangement?

Where to begin? In New York, the purpose of a statutory foreclosure action is to extinguish the borrower's equity of redemption. Any agreement whereby an owner's equity of redemption is automatically extinguished because of a future default would not be upheld.[12] Such an agreement, which would call for the loss of title triggered by an event of default without any foreclosure proceeding, would be viewed as clogging the equity of redemption in contravention of public policy. Further, any such agreement by which this deed was to be viewed as an absolute sale upon default, or by which the equity of redemption is to be waived, would be viewed as unconscientious, oppressive, illegal and void, and the equity of redemption would still reside in the owner.[13]

Such a deed, viewed in conjunction with the overall settlement agreement, would likely be treated as a mortgage[14] rather than an instrument conveying fee title to the real property. Accordingly, the equity of redemption remains in the owner, and may be extinguished only by procedure in compliance with statutory law.[15]

This arrangement is readily distinguishable from a standard deed-in-lieu situation. In the instant case, there is no continuing default (or, perhaps, there is a default and a forebearance), and the "deed" is executed with no present intent to transfer title. (In fact, there is no grantee named at all). In a standard deed-in-lieu situation, a default on the note and mortgage has already occurred, and the parties are entering into an arrangement calling for the present transfer of title in exchange for a present forgiveness of debt.

3. Your client is purchasing real property from a seller who is in Chapter 11. There is a confirmed plan of reorganization in place that calls for the subject real property to be sold free and clear of liens; the claims of the lien claimants attach to the proceeds of sale. There are open real estate taxes against the real property that go back several years. Are the real estate tax liens covered by the plan of reorganization? Why is the title company making an issue about the pre-petition taxes when they are covered by the plan?

As a matter of law, real estate taxes that are a lien at the time of the commencement of the bankruptcy case are a secured claim in a bankruptcy proceeding,[16] and a plan of reorganization can call for the property to be sold free and clear of the liens, which liens would attach to the proceeds. Real estate taxes that are a lien due and payable after the commencement of the case, however, cannot be so treated specifically because they arise after the commencement of the case; they must be paid out of the proceeds of sale or the lien survives the sale of the property.

Problems arise all of the time in the context of a bankruptcy where the real estate taxes are not paid at the time of closing. In many instances, the taxing authority was not named and served in the bankruptcy (and is therefore not subject to the court's jurisdiction).

Other times the tax collector will step up collection efforts after the property has been sold, and will pressure the new owner. In still other instances, when the post-petition taxes are paid, the payments are posted (as is the taxing authority's practice) against the oldest open liens, so that it is actually the pre-petition taxes that the taxing authority marks off; in this scenario, the post-petition taxes remain as a lien on the public records.

Each of these situations presents an immediate problem for a title company that issued an owner's policy of title insurance without exception for the taxes because its insured could rightly demand that the company pay the open taxes or otherwise clear the title of the liens that were not excepted from coverage.[17] It is prudent that the parties and the title company make special arrangements for dealing with the lien of pre-petition real estate taxes.

These arrangements can include actually paying the taxes out of the sales proceeds with the court's approval (rather than having them paid post-closing), having the court direct special payment of the pre-petition taxes, or working out an arrangement between the parties for dealing with the prospect that the taxing authority will not discharge the lien for pre-petition taxes. Remember, however, that any such "arrangement" will likely require the involvement and approval of the bankruptcy court if a portion of the sales proceeds are not going to be paid to the court.

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4. The client is the holder of a mortgage affecting property in New York City. The loan is now due, and the property owner and your client are negotiating an agreement whereby the loan will be extended and certain other changes (e.g., rate of interest) are being made. You have contacted the title company that issued a loan policy insuring the mortgage when it was made. However, the borrower does not want to pay a new title insurance premium at this time. Accordingly, you have agreed to ask the title company for a letter confirming that the agreement being signed does not impair the priority of the mortgage, but it is unwilling to do so. Why?

A so-called non-impairment letter is a letter from a title company that confirms that an instrument (usually a modification of mortgage) does not impair the priority of the lien of the mortgage as such priority was originally insured by the title company in its policy. Coverage along these lines is available in some states, either in the form of a letter or an endorsement.

This coverage is not available in New York; the only way to get similar protection in New York is to have the loan policy brought to date and to have the title company insure that mortgage as modified, but there is a substantial cost for this. The reason, plain and simple, that the non-impairment letter is not available in New York is that the granting of such protection is a form of insurance (because one would have to analyze the modification document to determine how it affects priority), and New York's regulatory scheme requires that charges be imposed as provided in the TIRSA Rate Manual. Further, in many cases, a determination could not be made on the effect of such a document on priority without running title to date and considering the results of that update and their effect on the priority of the mortgage as modified.

5. Your client is to purchase real property from a seller who is in bankruptcy. The seller has obtained an order pursuant to §§363(b) and 363(f) to sell the property free and clear of liens, but the title company is unwilling to issue a policy without exception to various liens on the property; apparently, it does not seem to understand what the meaning of the phrase "free and clear" is. Why are these liens an issue for the title company?

Bankruptcy Code §363(b) allows for the sale of assets of the debtor other than in the ordinary course of business after notice and a hearing provided that certain requirements are met. Section 363(f) allows such a sale to be "free and clear of any interest in such property of an entity other than the estate, only if:

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."

Throughout the country, courts are sharply divided on the proper construction of §363(f) in the context of a sale of property free and clear of liens where the proposed purchase price is insufficient to pay all lien claimants in full and one or more of the lien claimants objects to the sale. In other words, the battleground is the proper construction of §§363(f)(3) and 363(f)(5).

In cases interpreting §363(f)(3), the issue dividing the courts is whether the phrase "aggregate value of all liens" refers to the actual value as determined by the court under §506[18] or the total face amount of all liens as determined in the recent *Clear Channel* decision.[19] The first line of cases focuses on the use of the word "value" rather than "amount" and ties in the section to 11 U.S.C. §506(a).

The line of cases leading to *Clear Channel* argues, I believe persuasively, that the plain language of §363(f) and legislative history lead to a different result. It is also pointed out that "…in any case in which the value of the property being sold is less than the total amount of claims held by secured creditors, the total of all allowed secured claims will equal, not exceed, the sales price, and the statute requires the price to be 'greater than' the 'value of all liens.'"[20]

In the case of §363(f)(5), the issues appear to be (i) whether the holder of the interest at issue could be forced, in a legal or equitable proceeding, to take less than full payment for the interest, and (ii) whether the cram-down provision of the Bankruptcy Code (11 U.S.C. §1129(b)) is such a legal or equitable proceeding.[21]

It seems that most courts have accepted the rationale that the subdivision speaks to a proceeding that would require the holder of the interest to accept less than full payment; if full payment was required, the holders would be protected by 363(f)(3), and subdivision (5) would be superfluous.[22] There seems to be more disagreement among the courts on the question of whether §1129(b) is a legal or equitable proceeding as that phrase is used in §365(f)(5). It appears most courts have answered the question in the affirmative;[23] the *Clear Channel* court rejected the arguments outlined in these cases as circular.

6. The client is the holder of a series of mortgages covering parcels of land in several states, including one in New York. The loan(s) secured by these mortgages are in default, and the client has negotiated an agreement whereby the owner(s) of these various properties will deliver deeds in lieu of foreclosure that will transfer title to these properties to the mortgagee or its designee(s). You have engaged a title insurance company that will be issuing owner's policies of title insurance in connection with the deeds-in-lieu. Your client has requested that the title company issue a "creditor's rights endorsement." Your title company refuses to issue the creditor's rights endorsement on the New York parcel, and it is making requests for all sorts of documentation in connection with this request in the other jurisdictions. Why is this so difficult?

There are two different issues raised in our fact pattern. The first relates to the unwillingness of the title company to issue a "creditor's rights endorsement" on the policy covering New York property. This is appropriate since the endorsement is not an approved endorsement for use in New York, and its issuance would violate New York State Insurance Department regulations.

The second relates to the issuance of the endorsement elsewhere (presumably in states allowing for such issuance). The ALTA 2006 policy of title insurance excludes from coverage claims arising by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction vesting the title as shown in Schedule A, is:

(a) a fraudulent conveyance or fraudulent transfer; or

(b) a preferential transfer for any reason other than a failure of the instrument vesting title in the insured (i) to be timely recorded, or (ii) to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

This means that, for the title company to issue the "creditor's rights endorsement," it must conclude that the proposed transaction that will result in the vesting of title in a new insured is not potentially voidable under 11 U.S.C. §548 as a fraudulent transfer or under 11 U.S.C. §547 as a preference (or, in the case of each provision, applicable state law provisions). Because of the nature of the pre-existing debtor-creditor relationship between the parties to a deed-in-lieu situation, such a transaction requires enhanced scrutiny.

Further, because a title insurance policy covers costs of defense, the company must weigh significantly the prospect that third parties may seek to attack the transfer under these bankruptcy provisions; this often requires an analysis of the financial wherewithal of the transferor, and the company's determination of the prospect of a filing bears significantly on its willingness to provide creditor's rights coverage.

1. *Pennsylvania Steel Co. v. Title Guarantee & Trust Co.*, 193 N.Y. 37, rehearing denied, 193 N.Y. 682 (1908); *Security National Bank v. Village Mall at Hillcrest Inc.*, 85 Misc. 2d 771 (Sup. Ct., Queens Co., 1976).
2. *The New York Savings Bank v. Wendell Apartments Inc.*, 41 Misc. 2d 527 (Sup. Ct., Nassau Co., 1963).
3. *In Re Admiral's Walk*, 134 B.R. 105 (Bankr. Ct., W.D.N.Y., 1991).
4. *Howard Savings Bank v. Lefcon Partnership*, 209 A.D. 2d 473 (2d Dept. 1994).
5. *Security National Bank v. Village Mall at Hillcrest Inc.*, 85 Misc. 2d 771 (Sup. Ct., Queens Co., 1976).
6. *HNC Realty Company v. Bay View Towers Apartments Inc.*, 64 A.D. 2d 417 (2d Dept. 1978); *Yankee Bank for Finance and Savings, FSB v. Task Associates Inc.*, 731 F. Supp. 64 (N.D.N.Y. 1990).
7. *Security National Bank v. Village Mall at Hillcrest Inc.*, 85 Misc. 2d 771 (Sup. Ct., Queens Co., 1976). It is interesting to note that the subordination penalty was deemed available in this case even though to change the project to a condominium was disclosed on documents executed by the borrower and lender, recorded on the public record.
8. *In re Admiral's Walk Inc.*, 134 B.R. 105 (Bankr. Ct., W.D.N.Y., 1991).
9. *In re Grossinger's Associates*, 115 B.R. 449 (Bankr. Ct., S.D.N.Y., 1990).
10. *The New York Savings Bank v. Wendell Apartments Inc.*, 41 Misc. 2d 527 (Sup. Ct., Nassau Co., 1963).
11. *Howard Savings Bank v. Lefcon Partnership*, 209 A.D. 2d 473 (2d Dept. 1994).
12. N.Y. Real Property Actions and Proceedings Law Article 13 (McKinney, 2007). There is also a little-used foreclosure by power of sale statute in New York (RPAPL Article 14) which has been repealed effective July 1, 2009.
13. *Clark v. Henry*, 2 Cow. 324 (1823).
14. N.Y. Real Property Law §320 (McKinney, 2007); see also *Vitvitsky v. Heim*, 52 A.D. 3d 1103 (3d Dept. 2008); *Weiss v. Goffen*, 26 Misc. 2d 988 (Sup. Ct., Queens Co., 1960). It would seem that the deed in our situation, because it is given as security for an indebtedness that is secured by a mortgage that is already recorded, would be viewed by the Tax Law as a supplemental instrument under Tax Law §255.
15. *Lawrence v. The Farmers' Loan and Trust Co.*, 13 N.Y. 200 (1855).
16. 11 U.S.C. §506 (2008).
17. Such a problem is also likely to create a problem for a title company that issued a loan policy without exception for the taxes, though such a problem may be less immediate than in the instance of an owner's policy because the loss provisions of the two policies are different.
18. *In re Beker Industries Corp.*, 63 B.R. 474 (S.D.N.Y. 1986); *In re Rouse*, 54 B.R. 31 (W.D. Mo., 1985); *In re Feinstein Family Partnership*, 247 B.R. 502 (M.D. Fl., 2000). These cases tend to hold that the court must conclude that the proposed sale price is the best price obtainable under the circumstances, and/or that special circumstances exist justifying the sale for less than the amount of liens over the objection of a secured creditor.
19. *Clear Channel Outdoor Inc. v. Knupfer*, 391 B.R. 25 (B.A.P., 9th Cir., 2008); see also *In re WDH Howell, LLC*, 298 B.R. 527 (D.N.J., 2003).
20. *Clear Channel Outdoor Inc. v. Knupfer*, 391 B.R. 25, 34 (B.A.P., 9th Cir., 2008). See also *In re Gen. Bearing Corp.*, 136 B.R. 361, 366 (Bankr. S.D.N.Y. 1992).
21. *In re Terrace Chalet Apartments*, 159 B.R. 821 (N.D. Ill., 1993).
22. *In re Terrace Chalet Apartments*, 159 B.R. 821, 827 (N.D. Ill., 1993).
23. *In re Gulf States Steel Inc. of Alabama*, 258 B.R. 497 (N.D. Ala., 2002); *In Re Grand Slam U.S.A. Inc.*, 178 B.R. 460 (E.D. Mi., 1995).