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FINANCIAL newsletter

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WHEN SHOULD A LENDER ACCEPT A DEED IN LIEU OF FORECLOSURE?

During difficult economic times such as the present, the following scenario can be commonplace: A borrower is financially strapped for cash and there appears to be little or no likelihood that the borrower's operation can be successfully turned around. In situations like this, the lender will often need to evaluate when and how to seize its collateral to at least partially satisfy the borrower's debt. While a lender will often think that foreclosing on its real-estate collateral is the next step, there can be alternatives that are both less time consuming and less expensive. Specifically, for the reasons mentioned below, the lender should consider taking a deed in lieu of foreclosure instead of going through a foreclosure process.

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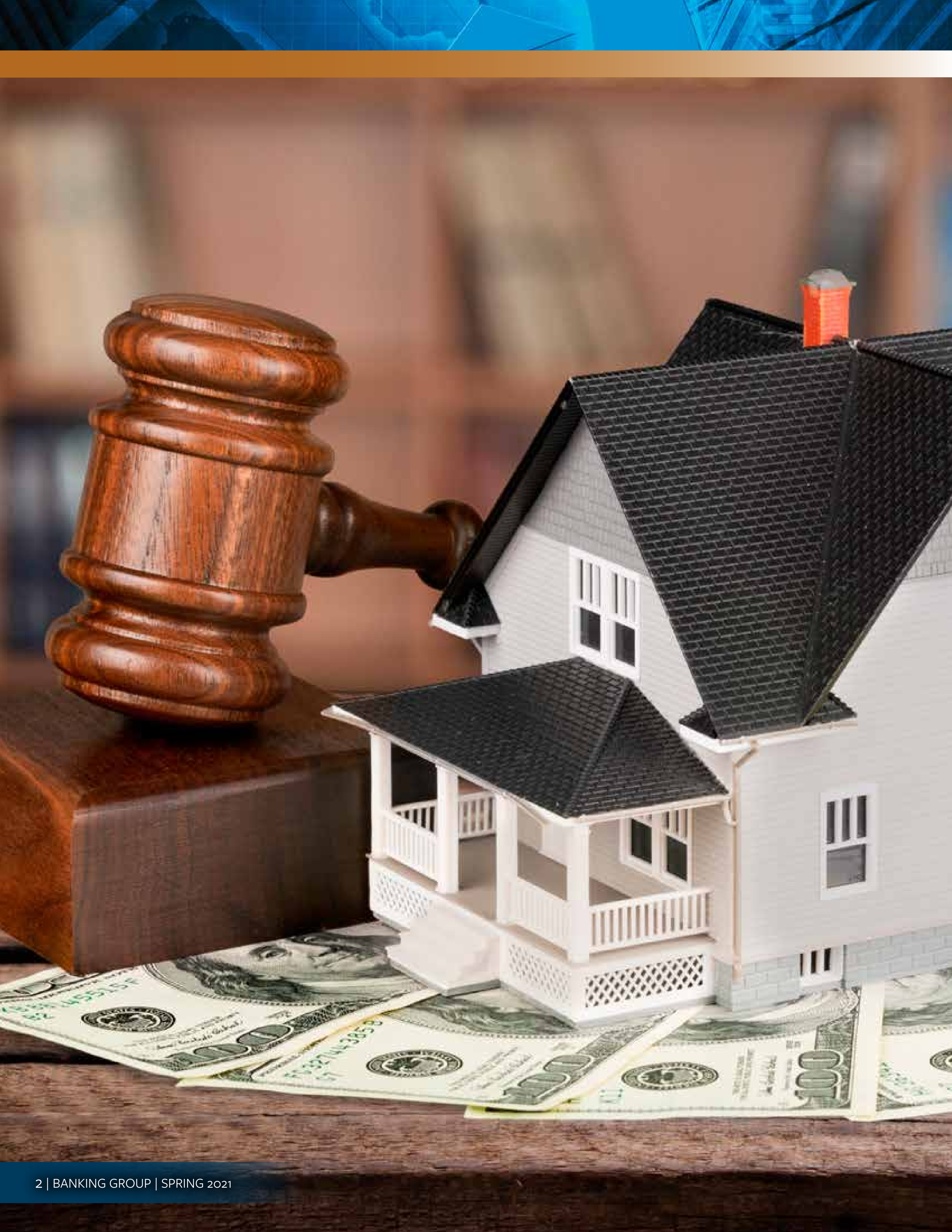

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Under Minnesota law, the lender has multiple options when it assesses how to liquidate real-estate collateral. For example, the lender could commence a foreclosure by advertisement or initiate a foreclosure by action. These two options each have pros and cons. A foreclosure by advertisement is a relatively quick process, and it is less expensive than a traditional foreclosure by action because it does not involve formal court action. However, one drawback of a foreclosure by advertisement is that the foreclosing lender will generally relinquish any deficiency judgment that the lender would be otherwise able to pursue in a foreclosure by action. In addition, a foreclosure by advertisement is not ideal when there are priority disputes among multiple lienholders, and it is unclear which lienholder is in the first-lien position.

In contrast, in a foreclosure by action the foreclosing lender can, among other things, resolve priority disputes among various lienholders who may be asserting competing liens against the real-estate collateral. Consequently, foreclosures by action can be useful when the foreclosing lender needs to obtain a court order to address priority disputes and/or "clean up" potential clouds on title to the real-estate collateral. However, because a foreclosure by action involves litigation, this process can sometimes be both expensive and time-consuming.

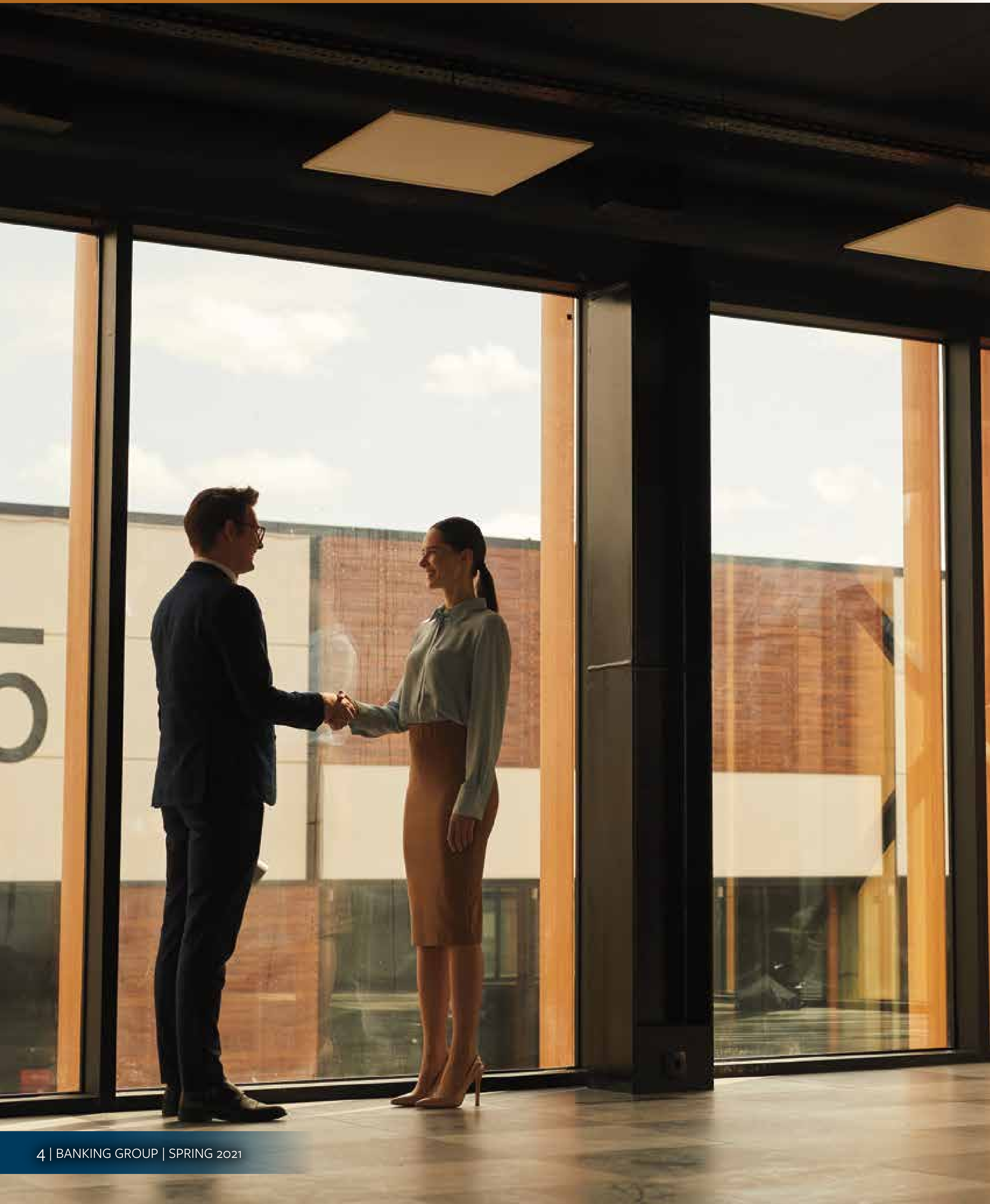
In both a foreclosure by advertisement and a foreclosure by action, the lender will also need to serve a number of notices upon the borrower (and sometimes others) in connection with the foreclosure. In addition, after the lender has complied with initial statutory foreclosure requirements, the real-estate collateral will be sold at a sheriff's sale. In these situations, the foreclosing lender will often submit a "credit bid" at the sheriff's sale, but even after the sale the borrower will generally have statutory redemption rights for a period of time established by law.

In sum, if a lender elects either foreclosure by advertisement or foreclosure by action, the lender will need to comply with various statutory requirements for completing either process, and generally the lender will not be able to take possession of the real-estate collateral until the foreclosure process is completed and the applicable redemption period has expired.

Depending upon the unique circumstances of a given case, the lender should consider taking a deed in lieu of foreclosure from the borrower instead of going through either of the above-referenced foreclosure processes. As the name suggests, taking a deed in lieu of foreclosure will generally allow the lender to immediately take possession of the real-estate collateral. Electing this option is generally far less time consuming than completing either a foreclosure by advertisement or a foreclosure by action. In addition, by taking a deed in lieu of foreclosure, the lender can immediately become the titled owner of the real-estate collateral. This means that unlike a foreclosure by advertisement or foreclosure by action, the lender will not need to wait for a statutory redemption period to expire before selling the real estate.

In situations where the borrower is cooperative and the lender believes that it can promptly sell the real estate to at least partially satisfy the borrower's indebtedness, it may be in the lender's best interest to simply take a deed in lieu of foreclosure instead of going through a cumbersome statutory foreclosure process. That said, deeds in lieu of foreclosure have pitfalls as well. For example, a lender may be reluctant to take a deed in lieu of foreclosure if the real-estate collateral has various environmental problems associated with it. In such a situation, the lender may be understandably hesitant to take title to the subject real estate out of a concern that doing so may expose the lender to liability under federal and/or state environmental laws or regulations. In addition, if the real-estate collateral is encumbered by liens that are junior to the lender's mortgage(s), then the lender may still need to complete a foreclosure process even after taking a deed in lieu of foreclosure to extinguish the junior liens. Although, junior lienholders may be willing to release their respective liens in exchange for either the borrower or the lender making a settlement payment to the junior lienholder for an amount substantially lower than the value of the junior lien.

In sum, when a borrower's operation becomes financially unsustainable and a lender begins looking at its collateral to satisfy the borrower's indebtedness, the lender should consider alternatives to foreclosing on its real-estate collateral. Depending upon the cooperativeness of the borrower, the existence (or non-existence) of any environmental hazards on the real estate, and the number and value of any junior liens encumbering the real estate, it may be beneficial for the lender to take a deed in lieu of foreclosure instead of electing to foreclose on the real estate.



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THE WHO, WHAT, WHERE, WHEN AND WHY OF AN SNDA

An SNDA—or Subordination, Non-disturbance, and Attornment Agreement—is an important tool for lenders to preserve the value of leased real estate collateral. As explained below, an SNDA provides important certainty and predictability to both the tenants and mortgagees dealing in the same real estate.

To understand the importance of an SNDA, a refresher on priority, mortgages, and foreclosures is helpful. A mortgage is lien on real property to secure a debt; it gives the mortgagee, often a bank or other lender, the right to have the property sold by the sheriff at a foreclosure sale to the highest bidder in the event the borrower defaults on the loan or other obligation. A foreclosure sale cuts off and forecloses the property owner's right of redemption, eliminating their rights in the property. It also has the effect of foreclosing and extinguishing any liens, judgments, leases, or other interests in the property that were granted after the mortgage, because those rights are junior to the mortgage. Conversely, any liens, leases, or other interests in the real estate that were granted before the mortgage are unaffected by the foreclosure.

An example helps illustrate how this works. Suppose a borrower owns a small office building with two spaces to lease. The owner enters into and records a ten-year lease with a pizza shop. Subsequently, the owner grants a mortgage to a bank. Finally, the owner enters and records a second ten-year lease with a salon for the other space. Five year's later, the owner defaults on the mortgage, and the bank forecloses.

Without any other agreements, as a general rule, the foreclosure will extinguish the salon's lease, because that lease was entered after and subject to the mortgage. At the same time, the pizza shop lease remains in place, and whoever purchases the property at the foreclosure sale will buy it subject to that pizza shop lease, because it existed before the mortgage.

Either result has its own advantages and disadvantages in different situations. On the one hand, eliminating junior leases on some properties may make it easier to liquidate or result in a higher price. For example, it may be difficult to fetch top dollar for farmland if a prior tenant is entitled to continue farming the property for several years before the lease expires if it is not extinguished. On the other hand, for a multiunit commercial space, being able to sell a fully occupied property with paying tenants may attract a better buyer interested in the ongoing lease revenue.

Enter the SNDA. The purpose of an SNDA is to subordinate any lease to the mortgage and provide that the lease will remain in force in the event of a foreclosure. Typically, the parties to an SNDA include the lender (mortgagee), landlord (mortgagor), and tenant.

The first component of an SNDA is a subordination, which subordinates the lease to the mortgage. Thus, even if the lease was entered into before the mortgage, the mortgage will be treated as superior to the lease. If there were a later foreclosure, the

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THE WHO, WHAT, WHERE, WHEN AND WHY OF AN SNDA

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mortgage, even if entered later, could wipe out the lease. This term is also useful for leases entered later, because it can stave off disagreements over whether a subsequent modification or renewal of the mortgage loan might affect its priority; instead, the mortgage will be treated as senior in all situations according to the terms of the subordination language.

The next component is a non-disturbance term. The non-disturbance language typically provides that so long as the tenant is not in default on the lease—e.g., the tenant is making its rent payments and otherwise performing—that the lease will remain in full force and effect if the lender forecloses the mortgage or otherwise enforces its rights under the mortgage. This provides some particular advantages for a tenant. Obviously, a tenant may be reluctant to invest the time and money into a new commercial space if it knows its rights could be immediately wiped out by a mortgage foreclosure. Thus, a non-disturbance agreement provides tenants with assurances that they will be able to continue leasing the space even if their landlord runs into financial troubles. With this protection available, the landlord may be able to attract better tenants and longer-term leases, leading to more stability for everyone.

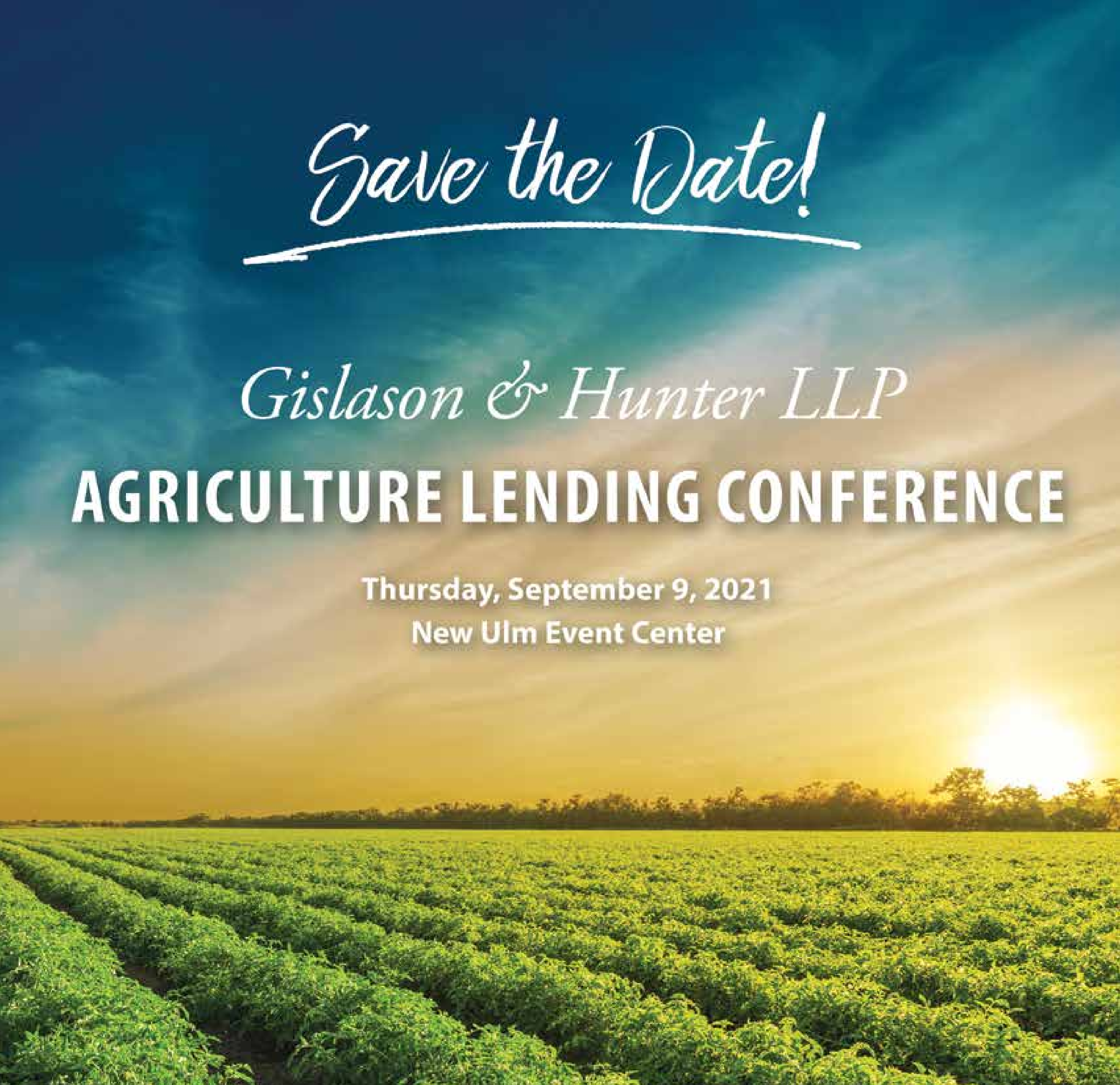
The final major part of an SNDA is attornment, providing that in the event that the property is foreclosed, the tenant will recognize and "attorn" to the new owner of the property in lieu of the landlord. In other words, when a new owner of the property purchases it at the foreclosure sale or from the bank following a foreclosure sale, the tenant will treat the successor owner as its landlord for all purposes, and the leases will effectively be between the tenant and successor owner going forward. This can help preserve the value of real estate in the event of foreclosure, allowing the bank to realize the most on its collateral, particularly with commercial real estate where its value may be significantly influenced by, and even measured by, the cash flow it generates from collecting rents. It allows a bank to liquidate a cash-producing asset, rather than a shell of a building with the hopes that the new owner will be able to find tenants.

SNDAs can include other provisions as well. For example, SNDAs can detail notification provisions and how rental payments should be paid after foreclosure. In addition, an SNDA might provide that, notwithstanding the lease terms, the bank is entitled to attempt to cure a breach of the lease by the landlord before the tenant can terminate the lease. For example, suppose a lease requires the landlord provide water to the tenants, but because of non-payment, the city shuts off the water to the building. A right-to-cure provision would allow the bank an opportunity to get the water turned back on before a tenant could terminate the lease for the landlord's default.

From a lender's perspective, requiring SNDAs as part of a mortgage loan may be particularly prudent when obtaining a mortgage on property where the value is derived primarily on the cashflow from renting the property. An SNDA gives lenders and successor owners assurances that the cashflow will continue even after foreclosure. One of the few major concerns of entering an SNDA is if the rental market appreciates and the existing lease requires too low of a rental rate; a bank or successor owner will be stuck receiving the lower rent through the duration of the existing lease. Further, for sites that might be more valuable as redevelopment, a successor owner will likely be limited from pursuing redevelopment until existing leases expire.

While commercial leases are one of the most common situations where the use of an SNDA arises, they arise in other situations as well. For example, a wind farm developer that enters into easements and leases with owners of agricultural property may insist that the mortgage holders enter into an SNDA before beginning construction. Without this, a wind farm developer risks having their turbine dismantled in the event a lender forecloses a mortgage on the underlying property. Other utility developers may have similar concerns that an SNDA can address. For other property such as agricultural real estate, having the option of terminating an existing tenancy is typically more valuable that the assurance of continued rents.

An SNDA agreement provides valuable assurances to landlords, tenants, and mortgage holders, particularly for commercial real estate. Understanding their components should help lenders make informed decisions about when one might be useful or valuable in a lending transaction or whether to execute one requested by a third-party.



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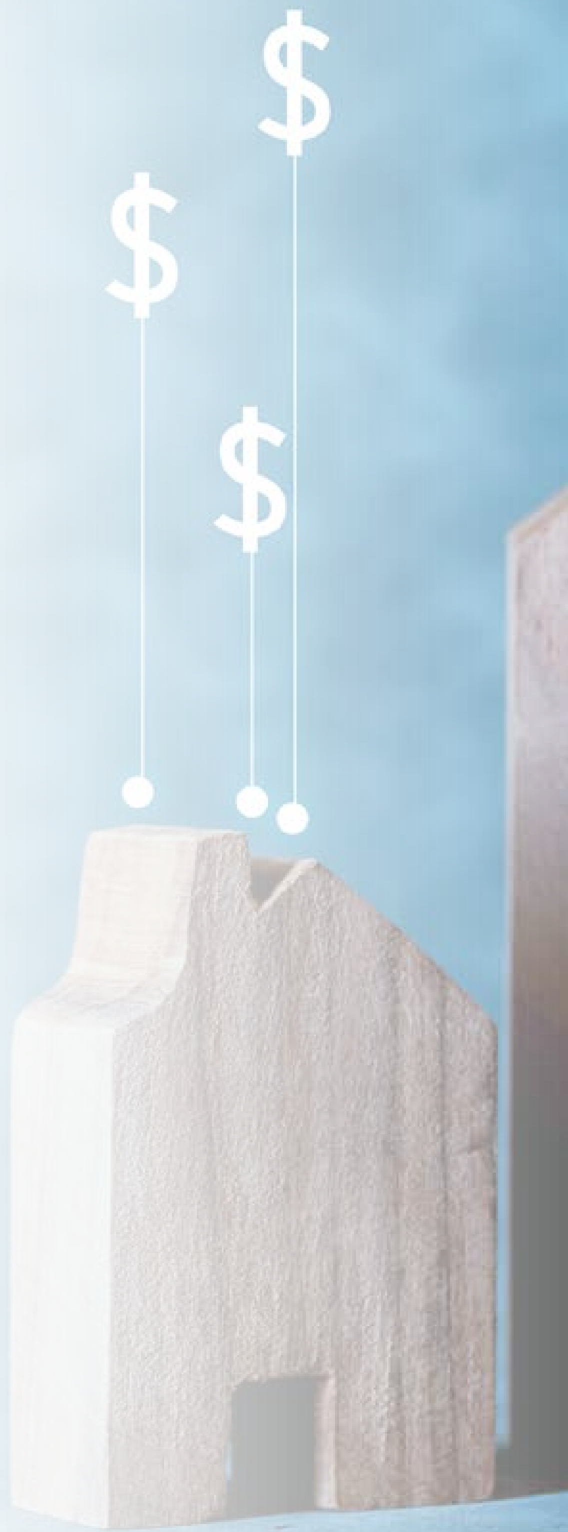

SPECIAL TOPICS RELATED TO SECURITY INTERESTS IN CASH PROCEEDS

In the context of a commercial or agricultural loan, personal property will often constitute an important part of a lender's collateral position. That personal property can take many forms, including equipment, inventory, farm products, accounts, and other intangible items. By implementing practices such as regular collateral inspections, lenders can typically track such property in a satisfactory manner, but unlike real property, personal property has the ability to be sold without detection or, potentially, a lender's consent. In such cases, lenders must sometimes resort to pursuing the cash proceeds of collateral instead of the collateral itself. This article discusses various items to be aware of and keep in mind when it comes to a lender's interest in cash proceeds.

From a strictly legal perspective, a lender will often be able to establish a valid security interest in the proceeds of its collateral. Article 9 of the Uniform Commercial Code provides that a security interest automatically attaches to any identifiable proceeds of collateral when sold and continues to be perfected for at least some period of time. Additionally, most security agreements will expressly provide that the lender's security interest extends to the proceeds of the property identified in the security agreement.

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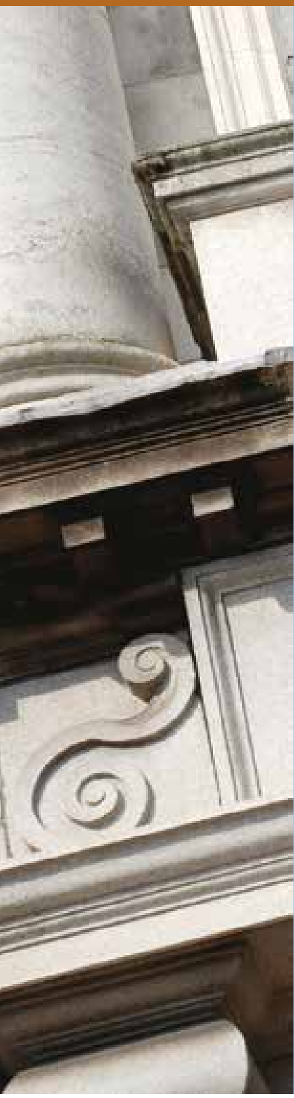
From a practical perspective, however, proceeds can be difficult to actually realize, especially when dealing with a troubled loan. Proceeds will often take the form of a check made payable to the borrower selling the piece of property. If no other payees are named on the check, the borrower will be able to endorse and deposit the check. Tracing and identifiability can then become murky when proceeds are commingled with other funds, and equitable considerations are often invoked to identify the proceeds. For example, commingled proceeds may be identified pursuant to the "lowest intermediate balance" rule, under which a security interest in proceeds attaches to the lowest amount of money in the borrower's bank account from the time the money from the sale came in and when the account is collected upon.

In the agricultural context, some of these issues are addressed by the federal Food Security Act, which provides mechanisms that lenders can use to become named as a co-payee on checks issued in exchange for agricultural products. In Minnesota, a lender can invoke those mechanisms by filing a form CNS-1 with the Secretary of State's office. But even with this system in place, problems can arise with obtaining full endorsement of the checks and depositing the checks before they become "stale." Under Article 4 of the Uniform Commercial Code, a bank is under no obligation to pay a check, other than a certified check, which is presented more than six months after its date, so lenders named as co-payees on checks should act with diligence. If there are issues with obtaining a borrower's endorsement on the check, the underlying security agreement may authorize the lender to endorse the check on the borrower's behalf.

Additionally, in both the commercial and agricultural context, if a borrower is a vendor of goods and the lender knows the identity of the entity or entities to which its borrower sells those goods, the lender can demand that the buyer fulfill its payment obligations to the borrower by submitting payment directly to the lender. In that situation, the borrower does not have the authority to receive

amounts owed to it directly or have recourse against the buyer based on the new payment arrangement.

Finally, lenders should be aware that a security interest continues in collateral that is sold or otherwise disposed of by a borrower unless the lender consented to the disposition free of the security interest. One exception to this rule concerns "buyers in the ordinary course," which are purchasers that purchase goods in good faith from a borrower that is in the business of selling those types of goods, and if this exception applies, the buyer obtains ownership free of a lender's security interest. If the exception does not apply, the lender may make claim to both the proceeds and the original collateral, although the lender may ultimately only have one satisfaction.



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