

## Current Issues in Complex Commercial Real Estate Litigation

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### Introduction

It is expected that a massive dollar amount of outstanding commercial real estate loans will default and enter into workouts over the next several years. The tide of resulting litigation is certain to rise. Here are some indicators of the scope of the problems to come:

- By some estimates, \$2 trillion in commercial real estate loans will mature over the next several years.<sup>1</sup> Commercial property prices fell as low as 43.7 percent below the peak, and are now down 40.2 percent from the peak.<sup>2</sup> And, as lending practices have come under increased scrutiny as a result of the global economic crisis, lenders have implemented stricter underwriting guidelines. It is possible that a majority of the loans maturing over the next few years will not qualify for refinancing.<sup>3</sup> Some estimates suggest that “[b]y 2011, 49 percent of maturing loans will have negative equity, followed by 63 percent in 2012, 61 percent in 2013, and 57 percent in 2014.”<sup>4</sup>
- Delinquency rates on construction loans have “already soared to 16 percent and could go much higher.”<sup>5</sup>
- Office vacancy rates are increasing and rents and property values are plummeting,<sup>6</sup> suggesting that many borrowers will be unable to service existing debt. Indeed, office vacancy rates are at 17 percent, “the highest level since 1994.”<sup>7</sup>

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- 1 See, e.g. Norm Alster, “Commercial Real Estate Loans a Growing Problem for Banks,” *Investor's Business Daily*, Nov. 3, 2009, at A1 (citing estimate of Richard Parkus, the head of commercial real estate debt research at Deutsche Bank Securities, that “[o]ver the next 15 months, \$2 trillion worth of commercial mortgages will mature.”); Sibley Fleming & Matt Hudgins, “Lenders Face Costly Problem,” *National Real Estate Investor*, Jan. 1, 2010, (citing Foresight Analytics for the proposition that \$270 billion in commercial real estate loans will mature in 2010); Ilaina Jonas & Elinor Comlay, “Whose fault is tight commercial property lending?” *Reuters News*, Dec. 24, 2009, (commenting that \$3.4 trillion in U.S. commercial real estate loans will mature over the next several years); “U.S. property faces long road to recovery - survey,” *Reuters News*, Dec. 18, 2009, (noting that \$1.4 trillion of commercial real estate debt will mature by the end of 2012).
- 2 *Moody's Investors Service, Moody's/REAL Commercial Property Price Indices March 2010*, at 1, [http://www.realindices.com/pdf/CPPI\\_0310.pdf](http://www.realindices.com/pdf/CPPI_0310.pdf).
- 3 See Terry Pristin, “In Commercial Sector, Hard Times Have Just Begun,” *N.Y. Times*, Sept. 2, 2009, at p. B8 (citing estimates that “[a]s many as 65 percent of commercial mortgages maturing over the next few years are unlikely to qualify for refinancing because of the drop in values and new stricter underwriting standards”).
- 4 Fleming & Hudgins, *supra* note 1, at 1.
- 5 Alster, *supra* note 1, at A1.
- 6 *Id.*; see also Pristin, *supra* note 3, at B8. (“Building values have declined by as much as 50 percent around the country, and even more in Manhattan, where prices soared the highest.”).
- 7 Ilaina Jonas, “At 17 pct, US office vacancy rate hits 15-year high,” *Reuters News*, Jan. 8, 2010.

- The number of loans held in commercial mortgage-backed securities (CMBS) structures that are being specially serviced has soared. As of February 2010, 9.55 percent of all CMBS loans by unpaid balance are being specially serviced.<sup>8</sup>

Many of the workout situations that have arisen recently have involved loans featuring complex structures, including CMBS loans, participation loans or other forms of syndicated debt. Litigation involving these complicated structures will give rise to a host of unique issues, both between the debtor and the lenders and among the lenders themselves. The difficulties inherent in these already complex litigations will be compounded by the fact that few courts have considered these lending arrangements. This article will explore some of these emerging litigation issues.

## Common Structures of Commercial Real Estate Loans

In the years leading up to the economic crisis, commercial real estate loan structures became increasingly complex, as leverage increased and the CMBS market expanded. Some of the more common structures are briefly summarized below.

### A. Single Loan Structures

*Co-lending and syndication* – In these structures, multiple promissory notes are secured by the same security instrument. The noteholders are all in direct privity with the borrower. The notes may be *pari passu*, such that the noteholders have equal rights to payment, or they may have a senior/subordinated structure, such that the payment rights of junior noteholders are subordinated to the rights of more senior noteholders.

The rights of the lenders, *inter se*, are typically governed by a co-lender agreement or intercreditor agreement. A lead lender and administrative agent often will be appointed to service the loan. Control over enforcement and workout decisions may be heavily negotiated. One common structure, however, is to provide the most junior noteholder with significant control rights with other noteholders retaining approval rights with respect to some major decisions. Major decisions requiring approval of all lenders may include, for example, increasing the principal amount of the loan, extending the maturity of the loan, permitting the borrower to take on additional debt senior to the loan, or releasing some or all of the collateral.<sup>9</sup>

Where a junior noteholder has control rights, those rights may be subject to a control appraisal process. Where the governing documents provide for a control appraisal event, the servicer or administrative agent is required to obtain an appraisal at certain points in time. If the value of the collateral declines because of market conditions (or otherwise), a holder may be “appraised out” of the control position if that value of the collateral no longer is sufficient to secure that lender’s note. A typical formulation would apply 90 percent of the appraised value of a property to the offered loan interests and other amounts due to determine which holder is in the control position. In some cases, a junior holder may

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8 According to Realpoint, as of February 2010, CMBS loans of approximately \$76 billion in unpaid balance are being specially serviced (9.55 percent of the outstanding balance of CMBS loans), compared to \$17 billion (2.04 percent) as of February 2009. Realpoint Research, *Monthly Delinquency Report - Commentary* (March, 2010), at 11, <https://www.realpoint.com/PublicDocDisplay.aspx?i=bMDgyzQuqE!%3d&m=i0Pyc%2bx7qZZ4%2bsXnymazBA%3d%3d&s=LviRtUKXqs8kml5dHt7FTeE2SZmY0Fvqd4iX49Mk%2f9UapyiFTEO6TA%3d%3d>.

9 See generally Talcott J. Franklin and Thomas F. Nealon III, *Mortgage and Asset Backed Securities Litigation Handbook*, §§ 8:17 - 8:24 (2009).

be permitted to post collateral and avoid an appraisal reduction event. If the appraisal shows that the controlling junior noteholder is no longer “in the money,” control rights will transfer to the most junior noteholder with an economic interest in the collateral. Depending on the terms of the relevant agreements, junior participants that have been appraised out may still retain the right to consent to major decisions. In addition, junior participants may, upon a default with respect to a more senior portion of the loan, be given the right to purchase the loan.

*Participations* – In these structures, a lender sells participation interests in a note to investors. Only the lender is in direct privity with the borrower. The holders of the participation interests have a contractual relationship with the lender under which they share in the proceeds of the note.<sup>10</sup> The loan is typically serviced by the lender, or an administrative agent, and the rights of the holders of the participation interests and the lender are governed by a participation agreement. The participation interests may have a senior/subordinate or *pari pasu* structure. Control and consent rights generally will be set forth in a participation agreement, and it is not uncommon for the most subordinate participant to have the right to direct enforcement of the loan, subject to a control appraisal and to approval rights over major decisions given to other participants.<sup>11</sup>

## B. Mezzanine Loans

In order to increase leverage, the debt structure on a commercial property may include one or more mezzanine loans. In a simple scenario, a mezzanine loan is secured not by the mortgaged property itself but by equity interests in the mortgage borrower, usually a bankruptcy remote special purpose vehicle (SPV). The mezzanine loan is structurally subordinate to the mortgage loan. Depending on the organization of the mortgage borrower, the collateral for the mezzanine loan may consist of membership interests in a limited liability company, limited and/or general partnership interests in a limited partnership or stock in a corporation. Thus, the security for the mezzanine loan is personal property and the remedies of the secured lender are governed by the Uniform Commercial Code, rather than real property law. As a result, a mezzanine lender may have greater flexibility in exercising remedies upon default through non-judicial procedures.<sup>12</sup> While in some states a mortgage lender may face a year or more of litigation to complete a sale of mortgaged property, a mezzanine lender may sell pledged collateral, and with it potential control of the mortgaged property, at a public or private sale under the UCC in a matter of a few months.<sup>13</sup>

In more complicated structures, there may be multiple tiers of mezzanine loans. For example, the financing structure for the Extended Stay Hotel chain, which has become the subject of a closely followed bankruptcy case (discussed in more detail below), involved 10 mezzanine loans, totaling \$3.3 billion in principal amount subordinate to a senior loan of \$4.1 billion secured by 681 individual hotels.

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10 See David S. Wolin and Adir E. Greenfeld, “Sorting Out Complex CMBS Structures,” *Commercial Real Estate Workouts and Restructurings 2010*, at 35, 42 (PLI Real Estate Practice, Course Handbook Series No. 578, 2010).

11 See generally Franklin and Nealon, *supra* note 9, at §§ 8:25 - 8:27.

12 The UCC provides both judicial and non-judicial remedies in the event of a default. See UCC §§ 9-601-624. A key remedy under the UCC is the ability of the secured party to sell the collateral without judicial intervention. See UCC § 9-610.

13 The UCC requires that “the method, manner, time, place and [terms]” of any sale of collateral must be “commercially reasonable.” UCC § 9-610(b).

Adding to the complexity, the individual mezzanine loans may themselves involve multiple lenders or participated interests. The rights of the mezzanine lenders and the mortgage lender are governed by an intercreditor agreement, which typically provides that the rights of the mezzanine lenders to repayment are subordinate to the rights to payment of the senior mortgage lenders. A mezzanine lender also may be provided with the option of curing any default by a borrower before the mortgage lender is permitted to begin foreclosure proceedings in order to give the mezzanine lender the opportunity to protect its interest, which may be wiped out if the mortgage lender forecloses. A mezzanine lender also may have the right to purchase the mortgage loan in certain circumstances and consent to certain modifications with respect to a more senior loan.<sup>14</sup>

### C. CMBS Structures

Commercial mortgage backed securities are a mainstay of the commercial lending market. In a CMBS structure, notes or senior participation interests in a number of different loans are deposited into a trust. Certificates constituting interests in the trust are then sold to investors, giving certificate holders a beneficial interest in the loans held by the trust. The certificates are often divided into tranches, and the rights of the different classes of certificates are generally set forth in a pooling and servicing agreement. In larger loans with multiple components, only a portion of the senior loan (the A-note) may be securitized, with a junior note (the B-note) held by other investors outside of the CMBS trust.

There are various parties involved in a CMBS structure other than a borrower and lender. These include the trustee which is charged with maintaining the accounts, distributing reports and money and a “master servicer” responsible for servicing the loans held by the trust provided that a “special servicer” has not been appointed. A special servicer services distressed properties and forecloses on the collateral where necessary. A special servicer is paid fees, including a special servicing fee (usually .25 percent per annum) and also may be paid a liquidation or workout fee (often 1 percent of amounts collected). Both the special servicer and the master servicer are obligated to perform their duties in accordance with accepted servicing practices, a standard that requires, among other things, that the servicer act with the prudence, care and skill that is customary for servicers in comparable transactions and by the servicer in other transactions.

A master servicer or special servicer must obtain the approval of the directing holder — the lender(s) or participant(s) contractually entitled to direct enforcement decisions — before taking certain actions. Such approval is generally required for major decisions, including major loan modifications, foreclosure or sale of the underlying property. The directing holder also typically has the right to replace a special servicer, subject to certain limitations including confirmation from the appropriate rating agencies that replacement of the special servicer will not cause a downgrade in the rating of the certificates. The directing holder may initially be an affiliate of the junior-most certificate holder, although the identity of the directing holder may change if the junior interests are traded or losses are realized by the trust or certain other events occur.

As mentioned above, portions of a loan may be held in a CMBS structure, and other portions held outside the structure. This allows for the combination of the different types of loan structures discussed above. For example, a mortgage loan may be securitized, while a junior mezzanine loan may be subject to a participation arrangement.<sup>15</sup>

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<sup>14</sup> See Wolin and Greenfeld, *supra* note 10, at 45-50.

<sup>15</sup> See Wolin and Greenfeld, *supra* note 10, at 50-59.

## Sources of Litigation

### A. Lender-Lender Disputes

In multiple lender situations, the likelihood of discord is enhanced, particularly where the lenders have different investment objectives. For example, in a given debt stack, some of the junior holders may have been “appraised out,” and lost control rights over the loan. These holders may be content if the loan were extended or renegotiated so that they can recover their investment if property values increase over time. Or, they may prefer that the collateral be realized upon in an orderly, consensual process that may salvage value for them. Although they may have little current economic interest in the loan, these holders may still retain approval rights over major decisions, which they could use as leverage to gain advantage in workout negotiations.

In contrast, the holder of the “fulcrum” interest — the most junior interest that is “in the money” and possibly in control of the loan — may be interested in controlling the underlying asset and may be unwilling to renegotiate the loan or grant extensions to the borrower.

Lastly, the holders of more senior interests may still be fully secured by the mortgaged property. These interests may be held by banks or pension funds that are most interested in recovering their principal and which may have little interest in controlling the asset. These holders may prefer an expeditious foreclosure process or a refinancing that will take them out.

These conflicting lender interests have sparked many of the battles in what has become known as “tranche warfare.”<sup>16</sup>

#### 1. *Control Over the Decision Making Process*

Lender versus lender disputes may take many forms, but one of the most common has been disputes over which lender controls the decision making and the impact of consent rights held by other lenders.

Now that many of these complex deals are being stress tested, often for the first time, it has become common to find ambiguities or inconsistencies in the documentation. While these ambiguities and inconsistencies may have gone unnoticed in better economic times, they provide fodder for inter-lender litigation when defaults do occur.

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<sup>16</sup> See, e.g., Nadja Brandt & Jonathan Keehner, “‘Tranche Warfare’ Erupts as Property Owners Slide Into Default,” *Bloomberg BusinessWeek*, Jan. 20, 2010 (“Infighting among lenders with different classes of debt, called tranches, is on the rise in the hotel industry and throughout the \$3.5 trillion market for commercial real estate loans after property prices fell more than 40 percent from their peak in 2007. Commercial mortgage defaults more than doubled to 3.4 percent in last year’s third quarter from a year earlier.”).

Lenders should understand precisely what decisions require consent from the lending group, and whether a lender adverse to the majority can take its own action.<sup>17</sup> This latter issue was addressed in a case that found its way to the New York Court of Appeals in 2007, *Beal Savings Bank v. Sommer*.<sup>18</sup> In *Beal*, a syndicated loan was made in connection with the development of the Aladdin Resort and Casino in Las Vegas. Under an ancillary keep-well agreement, the defendant and other sponsors of the borrower agreed, for the benefit of the lenders, to make certain equity contributions to the borrower in the event financial ratios of the borrower fell below certain levels. The borrower filed for bankruptcy protection, and, after the filing, plaintiffs' predecessor purchased an interest in the loan. Lenders holding more than 95.5 percent of the outstanding principal amount of the debt entered into a settlement agreement with defendant which directed the administrative agent to forbear from enforcing the keep-well agreement. Plaintiff then commenced its own action seeking to enforce the keep-well agreement. Defendant asserted that, pursuant to the credit agreement, only collective action by the syndicate was permitted and that the plaintiff was barred from bringing its own claim. Reviewing the entirety of the credit agreement, the Court of Appeals concluded that "based on the explicit language of the agreements and the provisions read as a whole, that the parties intended for collective action in the event that the obligations of the Borrower could be accelerated."<sup>19</sup> Although there was no provision of the credit agreement or the keep-well agreement excluding individual action by a syndicate member, the Court of Appeals concluded that the tenor of the agreements implied collective action. In particular, the court noted provisions of the credit agreement providing for the administrative agent, acting at the direction of a two-thirds majority of the lenders, to deliver default notices to the borrower and to enforce the lenders' rights and remedies.<sup>20</sup>

In dissent, Judge Smith commented that he would have reached the opposite conclusion. In the dissent's view:

A bank that is part of a lending group can, of course, agree that no suit will be brought unless a majority or super-majority of the lenders agree to take action, but if that agreement is made, it should be stated in plain language in the document. It is not hard to say: "No suit shall be brought except by the Administrative Agent, acting upon the

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<sup>17</sup> A lead lender, servicer, or administrative agent's failure to comply with applicable approval and consent requirements can, potentially, lead to significant liability, as illustrated by a recent decision by a Florida federal court in *PNC Bank, N.A. v. Branch Banking & Trust Co.*, No. 8:08-cv-610, 2010 U.S. Dist. LEXIS 12860 (M.D. Fla. Feb. 1, 2010). In that case, the court held a lender liable for nearly \$10 million for failing to comply with a Participation Agreement relating to a construction loan. Under the Participation Agreement, the defendant's predecessor in interest, Colonial Bank, had agreed to administer the loan, but could not, without the plaintiff's consent, modify or extend the loan or release any security for the loan, other than in connection with the sale of condominium units. The court found that Colonial, among other things, had agreed to release condominium units from the loan without payment of a minimum release price, advanced loan proceeds at times when the loan amount exceeded the permitted loan-to-value ratio, permitted the borrower to exceed the permitted number of condominium units under construction and inappropriately funded interest payments from reserve accounts. The court concluded that Colonial's conduct "effectively altered or modified material obligations, covenants and agreement of the borrower" without the required consent of its co-lender. *Id.*, at \*19. Servicers, administrative agents or other parties charged with administering a loan should take note of the *PNC Bank* decision, for the case illustrates that failing to hold a borrower to the strict terms of the loan covenants could be deemed to be a loan modification that requires consent under an applicable participation agreement or intercreditor agreement.

<sup>18</sup> *Beal Sav. Bank v. Sommer*, 865 N.E.2d 1210 (N.Y. 2007).

<sup>19</sup> *Id.* at 1219.

<sup>20</sup> *Id.* at 1215.

written instructions of the Required Lenders.” No such language, or anything that can fairly be read as its equivalent, appears in the Credit Agreement or Keep-Well Agreement, and I dissent from the majority’s decision to read it in.<sup>21</sup>

The *Beal* decision is useful in that it provides guidance as to how a court may interpret control rights where the loan documents are ambiguous, although it also illustrates the years of litigation that may ensue if the lenders’ rights are not clearly set out in the governing documents.

A different set of considerations from *Beal*, which involved a syndicate of lenders, may come into play where lenders under separate loans (e.g., a mortgage loan and a mezzanine loans) seek to enforce remedies. The rights of the lenders may be governed by an intercreditor agreement, but such an agreement may not be sufficient to prevent a determined lender from acting on its own. For example, in *Capital Trust, Inc. v. Lembi*,<sup>22</sup> a federal district court blocked efforts by senior lenders to enforce the terms of an intercreditor agreement to prevent a mezzanine lender from attaching assets of a guarantor. In *Capital Trust*, the plaintiff brought suit against various guarantors of a mezzanine loan and filed a motion to attach the defendants’ assets. The lenders on loans senior to the mezzanine loan, which also were guaranteed by the defendants, sought to intervene, arguing that the plaintiff’s attempt to attach the guarantors’ assets violated an intercreditor agreement. The court rejected the senior lenders’ arguments, as well as a similar argument by the defendants. The court held that the defendants had no standing to enforce the intercreditor agreement. As for the senior lenders, the court allowed them to intervene but still granted the plaintiff’s requested attachment. Although recognizing that the senior lenders might have a claim in the future for breach of the intercreditor agreement, the court held that the intercreditor agreement did not impact the validity of the plaintiff’s claims against the guarantor. Conversely, in the Southern District of New York, the district court denied summary judgment to a mezzanine lender who had sought a declaration that it could bring suit against guarantors of the mezzanine loan before the senior loan had been repaid, and granted the senior lender’s motion to enjoin enforcement of the guarantees supporting the mezzanine loan until the senior loan is paid in full. The court concluded that the contractual provisions of the intercreditor agreement “are obviously designed to ensure that the senior loan is paid in full before [mezzanine lender] is permitted to keep any money received in repayment of the mezzanine loan.”<sup>23</sup>

## 2. Junior Versus Senior Lenders

Another concern in complicated loan structures is that holders of junior debt may take actions designed to thwart the interests of the senior lenders (or threaten to take such action) in hopes of either forestalling a foreclosure or restructuring that would wipe out the junior debt or perhaps extracting

<sup>21</sup> *Id.* at 1219 (Smith, J., dissenting). The majority recognized that it would be preferable if the governing documents explicitly provided whether an individual lender could bring its own action. The majority noted:

We recognize that the contrary argument also can be made: had the parties intended to preclude the right to proceed individually, they should have said so explicitly. And surely, for the future, parties should expressly state their intention in this regard. It goes without saying, however, that if parties behave precisely as they should, there would be no ground for litigation; cases reach us only because question can be raised. Though question can be raised, here we are satisfied that the answer given by the trial court and the Appellate Division, based on the language and purport of the agreements, is the correct one.

*Id.* at 1218 n.3.

<sup>22</sup> *Capital Trust, Inc. v. Lembi*, No. C 09-02492, 2009 U.S. Dist. LEXIS 90001 (N.D. Cal. Sept. 16, 2009).

<sup>23</sup> *Highland Park CDO I Grantor Trust, Series A v. Wells Fargo Bank, N.A.*, No. 08 Civ. 5723, 2009 U.S. Dist. LEXIS 53272, at \*10 (S.D.N.Y. June 16, 2009).

concessions to permit them to realize value on an investment that would otherwise be under water. These disputes can take many different shapes and forms, including claims that the senior lender violated the terms of an applicable intercreditor agreement or breached the implied covenant of good faith and fair dealing.<sup>24</sup> The dispute also may involve the assertion of lender-liability type claims by the junior lenders against the senior lenders.

Current litigation arising out of the bankruptcy of Extended Stay Hotels (discussed further below) provides an interesting example of this type of litigation.<sup>25</sup> In one action, Line Trust Corp. (Line Trust), a participant in a seventh level mezzanine loan, brought claims against several more senior lenders, claiming that the senior lenders conspired with the borrower to cause the borrower to file for bankruptcy in order to wipe out the junior debt. The 2007 acquisition of the Extended Stay Hotels portfolio was financed with \$7.4 billion in loans. The financing consisted of a \$4.1 billion senior first mortgage which was then securitized. Behind the senior loan in seniority were ten tranches of mezzanine loans in the aggregate principal amount of \$3.3 billion. Certain of the mezzanine loans were then placed in participation arrangements, and the participation interests were sold. Line Trust alleges that it holds two participation interests in mezzanine loan G.

Line Trust complains about two courses of action allegedly pursued by senior lenders and certain entities that held positions in some of the more senior mezzanine loans. First, Line Trust complains that certain of the senior lenders also holding interests in senior mezzanine loans attempted to “wipe out” the junior mezzanine loans, thereby decreasing the debt of the borrowers to avert the commencement of mandatory amortization payments. According to Line Trust, these lenders “manufactured” a default under the loan documents, in which the administrative agent for the Mezzanine B lenders sent the borrower a notice of default. The “Original Lenders,” who allegedly continue to hold substantial positions in Mezzanine Loans B-E, allegedly conspired with the borrower to fabricate the default. Supposedly, under this plan the borrower would complete a conveyance in lieu of foreclosure whereby the membership interests owned by the Mezzanine B Borrower in the Mezzanine A Borrower would be conveyed to certain of the “Original Lenders” in their capacity as owner of the Mezzanine B Loan. Line Trust alleges that it was able to “thwart” this transaction by obtaining a temporary restraining order. Shortly thereafter, the borrower filed for bankruptcy.

The second aspect of Line Trust’s complaint concerns Extended Stay’s bankruptcy filing. Line Trust alleges that certain certificate holders of the senior loan conspired with the borrower and convinced it to file for bankruptcy protection, notwithstanding the large personal guaranties supporting the loans made by the principal of the borrower that were allegedly triggered by virtue of the bankruptcy filings.<sup>26</sup> Line Trust alleges that these certificate holders offered various inducements to the borrower to file bankruptcy, including an agreement to indemnify the principal from any liability under the guaranties. Line Trust alleges that the certificate holders hoped to advance their own interests by advo-

<sup>24</sup> Even in the absence of an agreement among the lenders, a senior lender may be under a duty not to administer the senior loan in bad faith. See, e.g. *Conn. Bank & Trust Co. v. Carriage Lane Assocs.*, 595 A.2d 334, 339 (Conn. 1991) (“The only duty [senior lender] owed [subordinate lender] was one of good faith.”); *Ranier v. Mount Sterling Nat’l Bank*, 812 S.W.2d 154 (Ky. 1991); see also David J. Marchitelli, Annotation, *Construction mortgagee-lender’s duty to protect interest of subordinated purchase-money mortgagee*, 13 A.L.R.5th 684.

<sup>25</sup> See *Line Trust Corp. v. Lichtenstein, Adv. Pro.* No. 09-01354 (S.D.N.Y.); *Line Trust Corp. v. Lichtenstein*, No. 601951/2009 (N.Y. Sup. Ct.). The case was originally filed in the Supreme Court for the State of New York, County of New York and was subsequently removed to federal court, where it was referred to the bankruptcy court administering Extended Stay’s bankruptcy. While the bankruptcy court remanded the action to state court, certain of the defendants have appealed the remand to the district court. At present, various dispositive motions have been filed in state court and in the bankruptcy court.

<sup>26</sup> The borrowers were special purpose entities, sometimes referred to as bankruptcy-remote entities.

cating a proposed plan of reorganization that would wipe out the junior debt and allow the certificate holders to obtain a large interest in the hotel portfolio. Line Trust asserts a variety of claims, against, among others, the senior lenders and the certificate holders. The claims asserted include claims of tortious interference with a contract, breach of the implied covenant of good faith and fair dealing and fraudulent concealment.<sup>27</sup>

While there has been no decision on the merits in the *Line Trust* cases, real estate litigators and bankruptcy lawyers continue to watch the case with interest.

Another recent example of a junior lender bringing claims against a senior lender played out in Bankruptcy Court in the Northern District of California. The dispute related to \$97 million in loans extended to a developer of property in Hawaii. A portion of the loan was secured by an “A Note,” and the remainder by a “B Note.” The holder of the A Note and the holder of the B Note entered into a co-lender agreement pursuant to which the B Note agreed to subordinate its claims to the holder of the A Note, and the holder of the A Note was given the right to service the loan. The borrower defaulted and, after extended negotiations, the holder of the A Note commenced foreclosure proceedings. The holder of the B Note sued, claiming that the holder of the A Note “engaged in commercially unreasonable conduct designed to frustrate [B Note holder’s] efforts to negotiate a work-out that would preserve the interests of both [A Note holder] and [B Note holder].”<sup>28</sup> The B Note holder alleged that this conduct was undertaken, among other reasons, “in an effort to eliminate all of [B Note holder’s] rights in the Loan, the security, the Property, and the project.”<sup>29</sup> The holder of the B Note asserted a panoply of claims, including breach of contract, breach of covenant of good faith and fair dealing, breach of fiduciary duty, bad faith waste, gross negligence and equitable subordination. The court dismissed both an original complaint and the majority of the amended complaint,<sup>30</sup> concluding that the relevant documents authorized the majority of the conduct or that the allegations failed to support the claims asserted. The court specifically noted “there is no commercial standard requiring a senior lender to put aside its interest in favor of the junior lender’s interest. Rather, senior lenders have very different interests from junior lenders, and generally have no obligation to protect their interests.”<sup>31</sup>

## B. Lender /Borrower Disputes

### 1. Disputes Arising out of Workout Negotiations

A common tactic for borrowers is to claim that the lender should be estopped or otherwise prevented from foreclosing on a mortgage based on allegations that, during workout discussions, the lender made promises to forebear enforcement of remedies, or to extend or refinance the loan at maturity.<sup>32</sup> The

<sup>27</sup> See Verified Complaint, *Line Trust Corp. v. Lichtenstein*, No. 601951 (N.Y. Sup. Ct. June 24, 2009).

<sup>28</sup> *In re CMR Mortgage Fund, LLC*, 416 B.R. 720, 727 (Bankr. N.D. Cal. 2009).

<sup>29</sup> *Id.* at 727-28.

<sup>30</sup> The court allowed a specific claim relating to a fee paid by the holder of the B Note to proceed. See *In re CMR Mortgage Fund, LLC*, No. 08-3148, 2009 WL 2870114, at \*5 (Bankr. N.D. Cal. Sept. 4, 2009).

<sup>31</sup> *Id.*

<sup>32</sup> Borrowers in New York often cite *Nassau Trust Co. v. Montrose Concrete Products Corp.*, 436 N.E.2d 1265, (N.Y. 1982) to support the proposition that an oral promise to modify a loan may forestall foreclosure. A recent case involving a residential loan reached a remarkable result that could have significant consequences if extended beyond its facts. In *IndyMac Bank F.S.B. v. Yano-Horoski*, 890 N.Y.S.2d 313 (N.Y. Sup. Ct. 2009), the court denied foreclosure and discharged the note and mortgage securing a residential loan (thereby allowing the borrower to keep the property and the proceeds of the loan) on the grounds that the lender had acted with “unclean hands” by failing to negotiate in good faith at settlement conferences and instead insisting on foreclosure. The concept that a lender could forfeit its entire loan based on the failure to negotiate toward a settlement appears to be unprecedented.

possibility that workout discussions will lead to such claims by the borrower is accentuated where there is a broader cast of lenders and other parties (such as a servicer) involved in the discussions. For example, while the borrower may deal with a servicer or administrative agent on a day-to-day basis, it may not regularly deal with the lender entitled to direct enforcement of the loan. Indeed, the borrower may not even know the identity of the controlling lender. Moreover, some refinancing or loan extension decisions may be major decisions requiring approval of all participants in the loan. This mismatch between the entity with whom the borrower has contact and the entities that have the ability to authorize a workout may increase the potential that a borrower receives mixed signals, which ultimately may form the basis for defensive allegations of estoppel or unclean hands.

In these circumstances, the lenders would be well advised to have in place, prior to any workout discussions, a comprehensive prenegotiation agreement with the borrower making it clear that, among other things, the servicer or administrative agent cannot guarantee that all required lender approvals will be obtained and that no discussions or negotiations will be binding unless reduced to a written agreement.<sup>33</sup>

One example of a dispute that arose out of a lending group's purported failure to negotiate with a borrower concerned an action affiliates of Donald Trump filed in connection with the Trump International Hotel and Tower in Chicago. Trump sued the senior lender, mezzanine lender and each of the participants in the loans, seeking an extension of the maturity date of the loans and certain other relief. One of the arguments Trump raised was that the initial lender breached duties to Trump by selling interests in the loan to entities with "no real estate lending experience and no understanding of real estate sales and marketing." Trump termed the participants the "Inappropriate Lenders" and alleged that the initial lender had improperly given too much control to these participants, and that the lack of experience and financial difficulties being experienced by the participants themselves rendered the lender group "dysfunctional." Apparently dissatisfied that he could not obtain certain amendments to the loans, according to Trump, the lender group was "unable to act" and has made it impossible to obtain "even the most routine amendments."<sup>34</sup>

## 2. Disputes Relating to Lenders' Failure to Advance Funds

Another area that has spawned several recent disputes is that of claims that lenders have breached their obligation to advance funds under a loan. Because replacement financing may be difficult to obtain, borrowers may be motivated to find a mechanism to compel the lenders to lend.

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33 A prenegotiation agreement has been held to be an effective defense against a borrower's attempt to rely upon Nassau Trust Co., 436 N.E. 2d 1265, as a means of defense. See *Fed. Home Loan Mortgage Corp. v. Drofan Realty Corp.*, No. 95 Civ. 5858, 1996 WL 15680, at \*3 (S.D.N.Y. Jan. 17, 1996) (distinguishing *Nassau Trust* because "not only did the Mortgage and Note in the Security Instrument prohibit oral modification but the parties agreed in the pre-negotiation agreement that any agreement to modify the terms of the mortgage and note had to be in writing and signed by the parties"). For a sample prenegotiation agreement, see Wallace L. Schwartz and David S. Wolin, "Workout Negotiations Outline", *Commercial Real Estate Workouts and Restructurings 2010*, *supra* note 10, at 71, 95-99.

34 See Verified Amended Complaint at 23, *Trump v. Deutsche Bank Trust Co. Ams.*, No. 26841/2008 (N.Y. Sup. Ct. Jan. 16, 2009).

It has traditionally been difficult to obtain an injunction or specific performance requiring the payment of money, because money damages ordinarily ought to be sufficient in such cases.<sup>35</sup> A recent New York decision, however, allowed such a claim in connection with the “Destiny USA” project, a proposed project that involved “development and construction of a shopping center/tourist destination containing at least 800,000 gross square feet and related facilities and improvements” in upstate New York.<sup>36</sup> The borrower claimed that the lender, Citigroup, improperly refused to fund certain draw requests and sought an injunction compelling Citigroup to fund. Although the dissent noted “[t]here is no authority under New York law that entitles a party to a preliminary injunction requiring a lending institution to loan money,”<sup>37</sup> the majority affirmed the grant of a preliminary injunction requiring Citigroup to fund the draw request. The majority opinion commented that “there has been a noticeable erosion of the rule that a borrower cannot obtain specific performance on an agreement to lend money,”<sup>38</sup> and considered the unique character of the Destiny USA project in determining that an injunction could properly issue. Despite the fact that there was no evidence that the borrower ever sought replacement financing, the court took “judicial notice of the economic conditions that prevailed when Citigroup ceased making the loan advances,” and concluded that the borrower would suffer irreparable harm if the injunction did not issue.<sup>39</sup> Thus, this case is noteworthy both because it affirms the grant of an injunction requiring the lending of money, and because of the willingness of the court to judicially notice the current economic situation and its impact on the ability to obtain alternate financing.<sup>40</sup>

Given the continuing difficult economic climate, borrowers emboldened by the recent opinion in New York approving an injunction requiring a lender to lend money can be expected to increasingly seek such relief.

## Bankruptcy Issues

### A. General Growth – Bankruptcy Remote Is Not Bankruptcy Proof

Special purpose entities (SPEs) are fixtures of complex commercial real estate lending. SPEs are entities that are thought to be “bankruptcy remote” in that their corporate documents require the board of directors to have independent members and require the consent of all directors before filing for bankruptcy. It was generally thought that independent directors would not authorize a bankruptcy filing as long as the SPEs’ assets were performing. A recent opinion, however, has raised questions about SPEs and just how bankruptcy remote they are.

<sup>35</sup> See, e.g., *BT Triple Crown Merger Co. v. Citigroup Global Mkts. Inc.*, 866 N.Y.S.2d 90 (table decision), text available at 2008 WL 1970900, at \*8 (N.Y. Sup. Ct. 2008) (refusing to grant summary judgment dismissing claim for specific performance of an alleged lending commitment but noting “[o]rdinarily, the New York courts will not order specific performance of a contract to lend money to a plaintiff, on the ground that money is fungible, and an injured party can borrow funds elsewhere and recover damages based on the higher costs it was forced to pay to the replacement lender”).

<sup>36</sup> See *Destiny USA Holdings, LLC v. Citigroup Global Mkts. Realty Corp.*, 889 N.Y.S.2d, 793, 796 (App. Div. 2009).

<sup>37</sup> *Id.* at 803 (Fahey, J., dissenting).

<sup>38</sup> *Id.* at 800 n.1 (citing *Bregman v. Meehan*, 479 N.Y.S.2d 422, 432 (1984)).

<sup>39</sup> *Id.* at 802. Although it did affirm the grant of an injunction, the Appellate Division required the borrower to post an undertaking in the amount of \$15 million.

<sup>40</sup> See also *BT Triple Crown Merger*, 2008 WL 1970900, at \*9 (declining to grant summary judgment against claim seeking specific performance of alleged commitment to lend funds in connection with an acquisition because triable facts had been raised as to “(1) whether [target] is ‘unique,’ (2) whether alternate financing can be procured for the Acquisition, and (3) whether the plaintiffs’ money damages can be proven with a reasonable certainty”).

In April 2009, General Growth Properties, Inc. (GGP)<sup>41</sup> and its operating partnership subsidiary, GGP Limited Partnership (GGP LP) commenced voluntary cases under Chapter 11 of the Bankruptcy Code. The filings by GGP and GGP LP were not a surprise, because they followed widely publicized efforts to voluntarily restructure. What surprised and concerned the commercial mortgage-backed securities (CMBS) market and the securitization world in general was the concurrent voluntary bankruptcy filings of more than 150 of its affiliated SPEs. Many property-level lenders sought to dismiss the Chapter 11 cases filed by various debtors, including numerous SPEs, owned directly or indirectly by GGP. The August 11, 2009 opinion by the United States Bankruptcy Court for the Southern District of New York denied the motions to dismiss. The property-level lenders argued that that cases should be dismissed for bad faith because the project-level debtors (i) were not in financial distress as of the petition date, making the bankruptcy petitions premature, and (ii) had engineered the bankruptcy filings by replacing the initial independent directors on the eve of the bankruptcy filings. Ultimately, in an opinion which suggests, among other things, that single-purpose, bankruptcy remote entities may not be as “bankruptcy remote” as was previously thought, the court found that bad faith was not present and denied the motions to dismiss. The court’s reasoning as to why bad faith was not present may have implications for the structure of SPEs.<sup>42</sup>

First, the court applied a broad definition of financial distress in evaluating the financial condition of each debtor as of the petition date to support its conclusion that the bankruptcy filings were not premature. Second, the court asserted that, despite the fact that SPEs are designed and intended to be separate and distinct from their corporate affiliates, when determining whether a bankruptcy petition has been filed in bad faith, it is appropriate to consider the interests of the corporate group as a whole. Third, the court confirmed that independent directors of SPEs cannot merely serve to protect the interests of creditors; instead, they have a fiduciary duty to protect the interests of the company and its shareholders. Lastly, the opinion suggests that the court may have been more receptive to the lenders’ arguments that the SPEs at issue should be excluded from the bankruptcy if the property-level lenders had provided an opportunity for such debtors to renegotiate the terms of their loans prior to the bankruptcy filing.<sup>43</sup>

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41 GGP is a publicly traded real estate investment trust that is primarily engaged in the business of owning and managing shopping centers. GGP is the general partner of GGP Limited Partnership, which controls, directly or indirectly, GGPLP, L.L.C., The Rouse Company LP and General Growth Management, Inc. which in turn directly or indirectly controls hundreds of individual project-level subsidiary entities. These project level subsidiaries directly or indirectly own the individual properties at issue in the bankruptcy case. *In re Gen. Growth Props., Inc.*, 409 B.R. 43, 48 (Bankr. S.D.N.Y. 2009). As a result of the collapse of the real estate markets and the resulting uncertainty regarding the ability to refinance the debt held by GGP and its affiliates, management decided to reorganize the corporate group’s capital structure by filing for Chapter 11 relief. *Id.* at 53-54. On April 16, 2009, 388 entities in the corporate group filed for Chapter 11 protection with an additional 27 filing on April 22, 2009. *Id.* at 48 n.6.

42 As noted by the Court, SPEs “are structured ... to protect the interests of their secured creditors by ensuring “that the operations of the borrower [are] isolated from the business affairs of the borrower’s affiliates and parent so that the financing of each loan stands alone on its own merits, creditworthiness and value.”” *Id.* at 49 (alteration in original) (citation omitted). To accomplish this, most SPEs have restrictions in their organizational and loan documents that require them to maintain a separate existence and limit the types of debt they can carry. In addition, their organizational documents usually contain “prohibitions on consolidation and liquidation, restrictions on mergers and asset sales, prohibitions on amendments to the organizational and transaction documents, ... separateness covenants [and] an obligation to retain one or more independent directors.” *Id.*

43 However, it is unclear whether the court would have reached a different conclusion because, before considering the argument that the debtors failed to negotiate prior to filing for bankruptcy, the court states that “[t]he Bankruptcy Code does not require that a borrower negotiate with its lender before filing a Chapter 11 petition.” *Id.* at 66. And while, “[t]here are often good reasons for a commercial borrower and its lender to talk before a bankruptcy case is filed, ... that does not mean that a Chapter 11 case should be deemed filed in bad faith if there is no prepetition negotiation.” *Id.*

Despite the argument that as of the petition date, most of the debtors at issue did not carry debt that was set to mature in the near future, and the properties held by the SPEs were, as a general matter, continuing to perform, the court found that each of the debtors at issue were in varying degrees of financial distress on the petition date. The court relied on the fact that a number of the debtors had loans that (i) “had cross-defaulted to the defaults of affiliates or would have been in default as a result of other bankruptcy petitions,”<sup>44</sup> (ii) had gone into hyper-amortization,<sup>45</sup> (iii) were set to mature or hyper-amortize in one, two or three years from the petition date, or (iv) had other characteristics that placed the loan in distress, such as a high loan-to-value ratio. The opinion suggests that the court’s willingness to view each of these factors as an indication of financial distress may have been due, at least in part, to the Court’s dire view of the CMBS market and the ability to refinance debt at the SPE level.<sup>46</sup>

### **B. Extended Stay – Required Disclosure of Identity of Certificate Holders**

As discussed above, the bankruptcy of Extended Stay Hotels involves numerous complicated loan structures, including a large senior loan and ten mezzanine loans. In what is perhaps an odd twist on the failed attempts by participants in a debt stack to bring suit directly, the debtor in the Extended Stay bankruptcy successfully argued that it is entitled to know the identity of the identity of the certificate holders holding interests in the securitized \$4.4 billion senior loan.<sup>47</sup>

The debtor claimed the identities of the individual certificate holders were needed because the information “is necessary and critical in order for the Debtors and their professionals to proceed with negotiating a plan of reorganization for the Debtors.”<sup>48</sup> The debtors apparently sought to negotiate directly with the certificate holders concerning the plan of reorganization. U.S. Bank National Association, in its capacity as successor trustee for the trust holding the senior loan (Trustee), opposed the debtor’s requested discovery, arguing that pursuant to the loan documentation, only the Special Servicer is entitled to negotiate with respect to the debt in question, and the certificate holders have no authority to exercise control over the property of the trust.<sup>49</sup> Because the certificate holders have no direct authority, the Trustee claimed that the debtor had failed to show “good cause” as to why the requested discovery should be allowed.<sup>50</sup> The Commercial Mortgage Securities Association (the CMSA) filed a joinder to the Trustee’s objection to the motion arguing that granting the requested discovery could

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44 *Id.* at 57-58.

45 According to the court, “[s]ome of the mortgage loans ... had an anticipated repayment date ... at which point the loan became ‘hyper-amortized,’ even if the maturity date itself was as much as thirty years in the future.” *Id.* at 50. The consequences associated with the failure to repay the loan on the anticipated repayment date included a steep interest rate increase, a requirement that cash be kept at the project-level, with excess cash flow being applied to the principal, and a requirement that certain expenditures be submitted to the lender for approval. *Id.*

46 *Id.* at 60-61.

47 Order, *In re Extended Stay Inc.*, No. 09-13764 (Bankr. S.D.N.Y. Nov. 19, 2009).

48 Notice of Debtors’ Motion for Entry of an Order Pursuant to Bankruptcy Rule 2004 Authorizing Discovery, at 2, *In re Extended Stay Inc.*, No. 09-13764 (Bankr. S.D.N.Y. Oct. 22, 2009).

49 Objection of U.S. Bank National Association, as Successor Trustee, With Respect to the Debtors’ Motion Pursuant to Bankruptcy Rule 2004 Authorizing Discovery, at 2-3, 5, *In re Extended Stay Inc.*, No. 09-13764 (Bankr. S.D.N.Y. Nov. 6, 2009).

50 *Id.* at 3, 5, 8.

have a chilling impact on the commercial mortgage-backed securities market.<sup>51</sup> The CMSA noted that a trust's internal governance procedures are not relevant to the borrower, and that the special servicer is the only entity with authority to act for the trust. The court ultimately concluded that the identity of the certificate holders "is potentially material to the debtor's ability to propose a workable plan structure" and "that it is reasonable for the debtor, independently, to conduct what I've called in my bench remarks, diligence. It is reasonable and appropriate for a debtor, in these circumstances, to understand who's driving the bus and who may be in the passenger seat," and ordered the discovery requested by the debtors.<sup>52</sup>

### Particular Concerns for Distressed Debt Buyers

The current market conditions present a variety of opportunities for investors to purchase loans at discounted prices. For example, an increasingly common tactic is the acquisition of mezzanine debt at a discount with an objective of possibly gaining control of the underlying asset in the event of a default.<sup>53</sup>

Distressed debt buyers pursuing these strategies should understand that they are buying into all of the potential litigation described above. When seeking to enforce rights under a defaulted loan, a debt purchaser also may open itself to claims by the borrower that defaults have been trumped up or that the new lender is acting in bad faith by pursuing contractual remedies. Still, courts have been reluctant to penalize parties solely on the grounds of alleged "loan to own" acquisitions.<sup>54</sup>

In New York, a common, although rarely successful,<sup>55</sup> borrower strategy was to assert that a lender that purchased a loan for the purpose of enforcing it was guilty of champerty. New York is one of the few

51 Joinder of the Commercial Mortgage Securities Association to the Objection of U.S. Bank National Association, As Successor Trustee, With Respect to the Debtors' Motion Pursuant to Bankruptcy Rule 2004 Authorizing Discovery, at 3, *In re Extended Stay Inc.*, No. 09-13764 (Bankr. S.D.N.Y. Nov. 11, 2009). The court gave little weight to the CMSA's filing, both because it was filed late and because "[m]arket convention is that deals like this don't end up in bankruptcy, that's the market convention. There is no market convention. There is no precedent for a case like this in the Southern District of New York." Transcript of Hearing, at 41, *In re Extended Stay, Inc.*, No. 09-13764 (Bankr. S.D.N.Y. Nov. 12, 2009).

52 See Transcript of Hearing, at 43, *In re Extended Stay, Inc.*, No. 09-13764. In commenting on the nature of the loans, the court stated: "These structures, whether we're talking about residential mortgages or commercial mortgages are terribly complex, complex beyond the ability of only the most sophisticated among us to truly understand and I won't comment as to the degree to which these structures helped lead us into the difficulties of the last few years." *Id.*

53 See Randy Drummer, "Tranche Warfare: Mezzanine Lenders Stepping Into Foreclosure Fray," *CoStar Group*, Sept. 2, 2009.

54 See, e.g., *In re Granite Broadcasting Corp.*, 369 B.R. 120, 125, 133-34 (Bankr. S.D.N.Y. 2007) (confirming reorganization plan notwithstanding bad-faith allegations premised in part on secured lenders' receipt of majority of equity in reorganized company); *In re InterBank Funding Corp.*, 310 B.R. 238, 251 (Bankr. S.D.N.Y. 2004) (dismissing claim premised on allegations of a "loan to own" scheme where claimant failed to show existence of such a tort).

55 See *Limpar Realty Corp. v. Uswiss Realty Holding, Inc.*, 492 N.Y.S.2d 754, 755-56 (App. Div. 1985) (acquisition of note and mortgage after default followed by an action to foreclose shortly after acquisition did not violate champerty law where acquirer was in the process of assembling other property on the same block and therefore had a "legitimate business purpose" for the acquisition). The Second Circuit has concluded that "the acquisition of a debt with intent to bring suit against the debtor is not a violation of the [champerty] statute where, as here, the primary purpose of the suit is the collection of the debt acquired." *Elliott Assocs., L.P. v. Banco De La Nacion*, 194 F.3d 363, 372 (2d Cir. 1999) (looking to whether the "primary purpose" of the purchase was to bring a lawsuit); see also *Bluebird Partners, L.P. v. First Fid. Bank, N.A.*, 731 N.E.2d 581, 589 (N.Y. 2000) ("To say the least, a finding of champerty as a matter of law might engender uncertainties in the free market system in connection with untold numbers of sophisticated business transactions — a not insignificant potentiality in the State that harbors the financial capital of the world.").

states that still has a champerty statute, meant to discourage trading in lawsuits.<sup>56</sup> In 2004, New York amended the statute to exempt transactions in which a debt or related debts of an obligor are purchased for more than \$500,000.<sup>57</sup> The amendment, by its terms, does not affect the rights of indenture trustees, but otherwise will effectively eliminate the champerty defense in most commercial loan situations. Although there are no cases interpreting or applying this amendment, the legislative history demonstrates that the amendment was intended to encourage trading in distressed debt.<sup>58</sup>

In addition, the New York Court of Appeals recently decided a case sharply limiting the application of the champerty statute. The facts underlying the decision are as follows: Love Funding entered into a mortgage loan purchase agreement with Paine Webber Real Estate Securities Inc. whereby Paine Webber provided the financing and was assigned the underlying loans for securitization, with Love Funding receiving a fee. In the mortgage loan purchase agreement, Love Funding represented that the loan was not in default, and agreed to indemnify Paine Webber from claims resulting from a breach of the representation. One loan assigned under the mortgage loan purchase agreement was a loan to Cyrus II Partnership, secured by a mortgage on an apartment complex in Louisiana. Paine Webber sold the loan to Merrill Lynch Mortgage Investors, Inc., and the loan was securitized with others and placed in a trust. The loan entered default, and it was learned that the borrower had committed fraud in connection with the origination of the loan, such that the loan had been in default from the outset. The trust sued Paine Webber, and with respect to the loan, Paine Webber agreed to assign any rights Paine Webber had against Love Funding to the trust in settlement. The Second Circuit certified questions regarding New York's champerty statute<sup>59</sup> to the New York Court of Appeals.<sup>60</sup> The Court of Appeals concluded that because the trust had a preexisting proprietary right with respect to the loan, the assignment of the claims did not violate New York's champerty statute.<sup>61</sup>

56 "The doctrine of champerty was developed 'to protect or curtail the commercialization of or trading in litigation.'" *Trust for Certificate Holders of Merrill Lynch Mortgage Investors, Inc. Mortgage Pass-Through Certificates, Series 1999-C1 v. Love Funding Corp.*, 918 N.E.2d 889, 893 (N.Y. 2009) (quoting *Bluebird Partners, L.P. v. First Fid. Bank, N.A.*, 731 N.E. 581, 582 (N.Y. 2000), *answer to certified question conformed*, 591 F.3d 116 (2d Cir. 2010).

57 N.Y. Jud. Law § 489 (McKinney 2005). Specifically, two new sections were added to the champerty statute providing:

2. Except as set forth in subdivision three of this section, the provisions of subdivision one of this section shall not apply to any assignment, purchase or transfer hereafter made of one or more bonds, promissory notes, bills of exchange, book debts, or other things in action, or any claims or demands, if such assignment, purchase or transfer included bonds, promissory notes, bills of exchange and/or book debts, issued by or enforceable against the same obligor (whether or not also issued by or enforceable against any other obligors), having an aggregate purchase price of at least five hundred thousand dollars, in which event the exemption provided by this subdivision shall apply as well to all other items, including other things in action, claims and demands, included in such assignment, purchase or transfer (but only if such other items are issued by or enforceable against the same obligor, or relate to or arise in connection with such bonds, promissory notes, bills of exchange and/or book debts or the issuance thereof).
3. The rights of an indenture trustee, its agents and employees shall not be affected by the provisions of subdivision two of this section.

58 The bill jacket indicates that the Legislature acted out of concern that distressed debt investors' "ability to collect on these [distressed] claims without fear of champerty litigation is essential to the fluidity of commerce in New York." N.Y. State Assembly, Mem. in Support of Legislation, Bill No. A7244C, at 1 (July 20, 2004). The Legislature intended "to avoid driving markets for such claims out of New York." *Id.*

59 N.Y. Jud. Law § 489 (McKinney 2005).

60 *Trust for Certificate Holders of Merrill Lynch Mortgage Investors, Inc. Mortgage Pass-Through Certificates, Series 1999-C1 v. Love Funding Corp.*, 556 F.3d 100 (2d Cir. 2009), *certified question accepted*, 906 N.E.2d 1064 (N.Y. 2009), *certified question answered*, 918 N.E.2d 889 (N.Y. 2009), *answer to certified question conformed*, 591 F.3d 116 (2d Cir. 2010).

61 *Trust for Certificate Holders of Merrill Lynch Mortgage Investors, Inc. Mortgage Pass-Through Certificates*, 918 N.E. at 895-96.

## Ethical and Privilege Concerns for Attorneys in Complex Commercial Lending Actions

The complexity of modern commercial lending arrangements leads to difficult questions for attorneys representing the lender(s), particularly where there are multiple lenders that must act as a group.

An attorney should consider at the outset of any such engagement which entities are within the scope of the attorney-client privilege. Lending participants may have different interests and may be represented by different counsel than is the lead lender or administrative agent responsible for directing the enforcement action. Notwithstanding this fact, it is likely that counsel will need to communicate or coordinate with the loan participants, at minimum, for purposes of keeping the participants informed. This may lead to difficult issues regarding the attorney-client and work product privileges. In these situations, care should be taken to insure that the joint defense or common interest doctrines protect the privileged nature of any such discussions, and circumstances may make it advisable to enter into agreements memorializing the nature of the communications to avoid any attempt to break the privilege.

A recent opinion from the Southern District of New York considered whether communications involving an administrative agent's counsel with non-party co-lenders are subject to the attorney client privilege. The court concluded:

Nordbank and the non-party lenders are co-lenders of the Loan and thus share a common interest in enforcing defendants' obligations under the Guaranties. Any doubt regarding this identity of legal interests is resolved by the terms of the Loan itself. Not only does the Loan identify Nordbank as the only party capable of "enforc[ing] or exercis[ing] any of the ... rights or remedies of or under any of the Loan Documents," but it also contemplates that Nordbank's counsel will effectively represent the interests of the various lenders, which interests are presumed to be identical. When viewed in conjunction with the fact that the relevant communications involve development of the appropriate legal strategy for obtaining relief, and that the parties privy to the communication understood the communication to be confidential on account of attorney-client privilege, these facts bring the communications at issue squarely within the common interest doctrine.<sup>62</sup>

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<sup>62</sup> *Hsh Nordbank AG N.Y. Branch v. Swerdlow*, 259 F.R.D. 64, 72 (S.D.N.Y. 2009) (alterations in original) (citations and footnote omitted). It should be noted that the parties at issue entered into a written common interest agreement after the date of the communications at issue. *Id.* at 72 n.12. In addition, the loan documents at issue contained a specific provision providing:

"Administrative Agent selected, and the other Lenders consented to the selection of, Sonnenschein Nath & Rosenthal LLP as Administrative Agent's counsel for all matters in connection with the Loan, the Project and the transactions contemplated by the Loan Documents. If, at any time during the term of the Loan, any Lender shall decide that its interests have become so divergent from the interests of the other Lenders or Administrative Agent that it does not feel it is prudent to be represented by the same counsel, such Lender may retain, at its sole cost and expense, its own counsel (but such Lender shall nevertheless remain responsible for its pro rata share of costs, expenses and liabilities including with respect to counsel selected by Administrative Agent.)"

*Id.* at 68.

Also, an attorney should clearly demarcate whose interests are being represented in an engagement. It is entirely possible that the interests of a lead lender or agent will not be perfectly aligned with the members of the syndicate or participants. Likewise, as discussed above, holders of junior notes may have different interests than holders of senior notes. For example, a junior lender who will be wiped out by a foreclosure may desire to give the borrower an extension, while a senior lender who will recover in full may wish to pursue a prompt foreclosure. An attorney at all times should make clear who her client is, and avoid giving the impression that any interests other than the client's are being protected. A misunderstanding about whose interests are being protected can give rise to numerous complications for the attorney.

This issue is illustrated in a series of decisions stemming from the documentation of the loans relating to the St. Regis Mohawk Tribe's Indian gaming facilities.<sup>63</sup> While the core of the dispute related to whether the law firm charged with documenting the transaction had committed malpractice, an ancillary but critical issue also arose concerning which entities had standing to bring a malpractice claim. Central to the dispute was whether counsel retained by the nominal lender and placement agent could be liable to participants that later purchased interests in the loan for errors made in connection with the transaction. Perhaps most noteworthy about the dispute is that the issue was considered by three federal courts (the Bankruptcy Court, District Court and the Eighth Circuit Court of Appeals) and a different decision was reached by each.

After a seven day trial in Bankruptcy Court in the District of Minnesota, the court, applying Minnesota law, concluded that the law firm, despite being retained by the nominal lender before the participants were even known, had an attorney-client relationship with each of the loan participants.<sup>64</sup> The district court, reviewing this aspect of the Bankruptcy Court's opinion de novo, reached a different conclusion. The district court concluded that no direct attorney client relationship was formed between the law firm and the participants in connection with the drafting of the original loan documents, and that at the inception of the relationship the law firm was counsel only to the nominal lender, specifically noting that "[a]t the time of the retention, the participation agreements had not even come into being."<sup>65</sup> The court went on to conclude, however, that the law firm later entered into a direct attorney-client relationship with the participants when the law firm undertook to provide advice to the participants regarding rights and remedies under the loan documents.<sup>66</sup>

After the bankruptcy court and district court had ruled, the Minnesota Supreme Court issued a decision in a related matter stemming from the same transactions that had been considered by the bankruptcy and district courts.<sup>67</sup> The Minnesota Supreme Court concluded that the participants were not "direct and intended beneficiaries of the attorney-client relationship," and that the purpose of the

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<sup>63</sup> See *Bremer Bus. Fin. Corp. v. Dorsey & Whitney LLP* (In re SRC Holding Corp.), 352 B.R. 103 (Bankr. D. Minn. 2006), aff'd in part, rev'd in part, 364 B.R. 1 (D. Minn. 2007), rev'd sub nom. *Leonard v. Dorsey & Whitney LLP*, 553 F.3d 609 (8th Cir. 2009).

<sup>64</sup> *Id.* at 169-70.

<sup>65</sup> *Bremer Bus. Fin. Corp. v. Dorsey & Whitney LLP* (In re SRC Holding Corp.), 364 B.R. 1, 27 (D. Minn. 2007), rev'd sub nom. *Leonard v. Dorsey & Whitney LLP*, 553 F.3d 609 (8th Cir. 2009).

<sup>66</sup> *Id.* at 29-33.

<sup>67</sup> *McIntosh County Bank v. Dorsey & Whitney LLP*, 745 N.W.2d 538 (Minn. 2008).

underlying transaction was not to benefit the participants, but instead to close the loans.<sup>68</sup> The court thus concluded that the law firm could not be liable to the participants for malpractice.<sup>69</sup>

In the federal proceedings, the Eighth Circuit had the final say. The Eight Circuit viewed the Minnesota Supreme Court's decision as controlling, and concluded that there was no attorney-client relationship between the participants and the law firm.<sup>70</sup> In so concluding, the Eight Circuit emphasized its view that participation loans are "arm's length" transactions, and that "[b]ased on a belief that financial institutions have the resources to adequately protect their own interests, courts have typically dismissed bank requests for judicial protection in participated loan transactions."<sup>71</sup> The court further predicted that Minnesota law "would hold [participant] to the marketplace standards of vigilance and independent inspection, and not grant it any protection beyond the express terms of the Participation Agreement."<sup>72</sup>

Thus, while claims that the law firm discussed above had an attorney-client relationship with participants in a participation loan were all ultimately dismissed, the tortured procedural history of the cases and the disparate outcomes reached at the different levels demonstrates the risks confronting counsel for a lead lender in such a transaction.<sup>73</sup> These similar concerns could arise in any number of complicated lending transactions. An attorney must take extreme care to insure that all parties involved in the loan are aware of exactly whose interests are represented by the attorney.<sup>74</sup>

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68 *Id.* at 548.

69 *Id.* at 548-49.

70 *Leonard v. Dorsey & Whitney LLP*, 553 F.3d 609, 626-28 (8th Cir. 2009).

71 *Id.* at 625.

72 *Id.* at 626.

73 Similar issues also were considered with respect to the existence of an attorney-client privilege in a line of older cases. *See re Colocotronics Tanker Sec. Litig.*, 449 F. Supp. 828, 832 (S.D.N.Y. 1978) (determining loan participants were not clients of attorneys hired by lead bank); *Resolution Trust Corp. v. Colonial Cheshire I Ltd. P'ship (In re Colonial Cheshire I Ltd. P'ship)*, 130 B.R. 122 (Bankr. D. Conn. 1991).

74 For a detailed analysis of the role of lead counsel in syndicated lending transactions, see Reade H. Ryan, Jr. *The Role of Lead Counsel in Syndicated Lending Transactions*, 64 Bus. Law. 783 (2009).