Good News for Multifamily Property Owners: The Freddie Mac CME Program

By Jeffrey S. Scharff and Teresa L. Cella

The Federal Home Loan Mortgage Corporation (Freddie Mac) launched its Capital Markets Execution (CME) Program as an alternative source of financing for multifamily property owners during the height of the economic crisis. Since its inception in 2008, the Freddie Mac CME Program has originated approximately $25 billion of loans across the country. Like other CMBS loans, CME multifamily loans are pooled together and subsequently securitized and sold and are therefore subject to rating agency requirements. As a result of the securitized structure, CME Program multifamily loans are offered on generally more favorable terms than standard portfolio loans, making them a potentially attractive source of financing to borrowers.

PROS AND CONS

The availability of funds through a government sponsored entity (GSE) during one of the most severe credit crunches has proven to be a real lifeline for buyers and owners of multifamily properties in the last few years. While GSE funds are also available through Freddie Mac's conventional mortgage program offerings (as well as loan programs offered by Fannie Mae), CME Program financings typically yield higher proceeds and lower spreads than portfolio execution. As a result, the CME Program has become a very attractive source of financing to multifamily operators. The CME Program is also attractive to owners of older/non-trophy properties, which may not meet underwriting criteria for other categories of lenders.

While the availability of low-cost financing has fueled this growing program, borrowers must be prepared to execute Freddie Mac's standard CME Program loan documents with extremely limited modifications. The lack of flexibility will come as no surprise to borrowers accustomed to Freddie Mac's and Fannie Mae's conventional mortgage programs, but will be a shock for borrowers more accustomed to negotiating with commercial banks and insurance companies. Like traditional CMBS deals, borrowers are expected to comply with strict special purpose entity requirements (which get stricter as the loan size increases), including delivery of complex and costly "non-consolidation" opinions for deals of $25 million or more. Finally, borrowers who prefer yield maintenance to defeasance when a prepayment is made should expect to pay a higher interest rate. After the loan is securitized, the standard CME Program loan documents provide only for defeasance, as is common in securitized financings.

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Bad Boy Guarantees — Michigan Decisions are More Bad News for Guarantors

By Henry S. Healy

Loan documents for commercial real estate loans frequently state that, subject to limited exceptions, the borrower will have no personal liability for loan obligations. The lender's sole recourse is to the collateral for the loan. The loan documents usually contain a number of provisions intended to deter a voluntary bankruptcy and to insulate or "ring-fence" the borrower in order to keep it separate from related entities. These are intended to keep the borrower "bankruptcy remote." They are also intended to reduce the risk of substantive consolidation with related entities in the event of a bankruptcy. As an exception to the nonrecourse terms, the loan documents include provisions that make the loan full recourse to the borrower if the separateness covenants are violated.

Loan documents for this type of loan also commonly include a "bad boy" guaranty from a principal of the borrower stating that the guarantor will become fully liable in the event that specified "bad acts" occur. This type of guaranty is intended to protect the lender against conduct by the guarantor that adversely impacts the collateral or interferes with the lender's exercise of its rights under the loan documents. Two recent Michigan cases where lenders sought to enforce a "bad boy" guaranty have resulted in decisions that are bad news for guarantors. In both of these cases, a combination of separateness provisions frequently found in loan documents and the terms of the bad boy guaranty led the court to rule that the guarantor was fully liable. In both cases the only violation was the failure of the borrower to remain solvent and pay its debts as they came due.

The *Chesterfield Development Company* case was decided by the United States District Court for the Eastern District of Michigan on Dec. 12, 2011. It concerned a mortgage loan on a Michigan shopping center. The borrower defaulted, and after foreclosure on the shopping center, the lender sued the guarantor for the deficiency. Under the terms of the guaranty the guarantor agreed to be liable for all recourse obligations of the borrower contained in the note. The note stated that subject to specified exceptions, the borrower would have no personal liability for the loan obligations. One of the exceptions was that in the event of any failure to comply with certain provisions of the mortgage the borrower would be fully liable. One of these provisions required that the borrower not "become insolvent or fail to pay its debts and liabilities from its assets as the same shall become due." The court granted summary judgment for the lender. It ruled that the failure of the borrower to make payments on the loan violated these provisions of the mortgage. The court rejected arguments by the guarantor that the terms of the documents were ambiguous and that the result was against public policy.

A few weeks later the Michigan Court of Appeals decided the *Cherryland* case. There the borrower obtained a commercial mortgage loan secured by a mortgage on a Michigan shopping mall. The loan was subsequently made part of a commercial mortgage backed securities pool. A principal of the borrower provided a bad boy guaranty. The loan documents contained nonrecourse provisions, subject to specified exceptions. One of these exceptions was that the borrower would be fully liable for the debt in the event that the borrower "fails to maintain its status as a single purpose entity as required by, and in accordance with, the provisions of the Mortgage." A paragraph of the mortgage, titled "Single Purpose Entity/ Separateness," included a provision stating that "Mortgagor is and will remain solvent and Mortgagor will pay its debts and liabilities…from its assets as the same shall become due." The borrower failed to make payments on the loan, and the CMBS trustee foreclosed on the mall. In an action by the CMBS trustee against the guarantor to collect the deficiency, the trial court found for the trustee. On appeal, the Michigan Court of Appeals affirmed the decision of the lower court. The Court of Appeals found that the solvency covenant formed part of the single purpose entity provisions of the mortgage and that the borrower's failure to make payments violated the solvency covenant. As a result the court ruled that the decision of the trial court was correct, that the loan became fully recourse and that the guarantor was liable for the deficiency. Again, the court found no ambiguity in the terms of the loan documents and rejected arguments based on public policy. It also rejected the guarantor's argument that a breach of the solvency covenant should only result in full recourse against the guarantor if the violation of its terms was a failure to remain solvent or pay indebtedness that was caused by guarantor's own actions.

Some commentators have criticized these decisions on the basis that despite the nonrecourse terms of the loan documents the exceptions have swallowed the rule. In effect, the loans have been made fully recourse against the borrowers and the guarantors — a result that was not intended

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Circumventing the Secured Lender's Right to Credit Bid — the Dubitable Nature of "Indubitable Equivalent" Collateral

By H. Scott Miller

Indubitable *(in•dü•bə•tə•bəl)*: too evident to be doubted; unquestionable.

(Merriam-Webster Dictionary; http://www.merriam-webster.com)

A statute uses the word "indubitable," and some of the most accomplished federal judges in the U.S. can't agree on what it means. The basis of a new "lawyer" joke? Hardly. This is important fodder for bankruptcy commentators.

And nonrecourse real estate lenders — undoubtedly — should pay attention.

Whether an emerging trend or a coincidental confluence of cases, bankrupt borrowers and unsecured creditors appear to be testing the concept of "indubitable equivalent" collateral in an effort to tilt cramdown proceedings in their favor.

The issues relate to the position of a secured creditor (such as a real estate mortgage lender) wrangling in a bankruptcy proceeding and facing the prospect of having a reorganization plan approved (or "crammed down") over its objection. The secured creditor has some statutory protection — Section 1129(b)(2)(A) of the Bankruptcy Code provides three alternative requirements for "cramdown" reorganization plans to ensure that the secured real estate lender will still achieve a "fair and equitable" result to the extent of its secured claim.

The first "fair and equitable" alternative is that the reorganization plan must provide a continuation of the lender's security interest in the collateral to the extent of its secured claim, with equivalent value for the indebtedness owing to it. What constitutes equivalent value is the subject of much posturing (think extended terms and present valuations), but is irrelevant to the issues being discussed in this article.

The second alternative is that the collateral can be sold in a sale under Section 363 of the Bankruptcy Code. In this situation, the lender usually tries to protect itself by credit bidding the amount of its secured claim to ensure that the property is not sold at a steep discount to value.

The third alternative is that the secured lender receives the "indubitable equivalent" of its existing claims.

Although the concept of what constitutes the "indubitable equivalent" of a secured lender's claim initially arose from the pen of Judge Learned Hand in a 1935 case, there is a lack of judicial guidance in interpreting this phrase, and today we have splits among Circuit Courts of Appeal. Later this year, the U.S. Supreme Court will be hearing the issues.

The direct issue in these cases is whether the "indubitable equivalent" alternative can be used as an end-around other protections afforded secured lenders under the Bankruptcy Code.

Most of the hubbub regarding these recent cases involves the use of the "indubitable equivalent" alternative to circumvent a secured lender's right to credit bid the amount of its debt in a transfer or sale of its collateral. Three cases highlight the issues here.

The first appellate airing of this issue percolated at the 5th Circuit Court of Appeals in its September 2009 decision *In re Pacific Lumber, Co*. In this case, one secured lender's loan was collateralized by an interest of more than 200,000 acres of timberland owned by a specific entity. In bankruptcy, the court valued its collateral at $510 million — approximately $230 million less than the underlying indebtedness. Another creditor (in this case, a creditor of an affiliate of the timberland-owning entity) developed a reorganization plan affecting the sponsor and the entire enterprise. This plan called for the transfer of the timberland to a newly formed entity.

What should the timberland lender have expected? Had the plan preserved its lien on the timberland, it would have been entitled to payment streams bearing the equivalent of $510 million in value. Had the plan called for the sale of the timberland under Section 363 of the Bankruptcy Code, the lender would have been entitled to credit bid its full $740 million claim in order to prevent an undervalued conveyance.

Instead, the plan called for the transfer of the timberland to a new entity and a cash payment to the secured lender in the amount of $510 million as the "indubitable equivalent" of its existing secured claim.

The secured lender argued that the $510 million valuation was too low and that the "indubitable equivalent" approach was an end-around its right to credit bid in a Section 363 auction format to protect against an undervaluation. The court was not sympathetic, effectively stating that its valuation was binding and that Section 1129(b)(2)(A) did not

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LLC Managers Beware: You May Have Fiduciary Duties

By Marc Anthony Angelone

On Jan. 27, 2011, the Chancery Court of Delaware ruled that fiduciary duties are implicit in Delaware limited liability company agreements. A simple voting majority, by itself, does not give a limited liability company's manager free rein to take self-serving actions to the detriment of its minority investors. Unless a limited liability company's operating agreement contains an express provision waiving or modifying a manager's duties of loyalty and care to its members, these fiduciary duties are implicit in the agreement.

BACKGROUND

In the case in question, *Auriga Capital Corp. v. Gatz Properties Inc.*, the manager (the "Manager") of a Delaware limited liability company (the "LLC") and his family acquired majority voting control over the LLC's equity and held a veto over any strategic option. The LLC held a long-term lease on a valuable property owned by the Manager and his family. The lease allowed the LLC to operate a golf course on the property. The LLC subleased the golf course for actual operation by a large golf management corporation.

It quickly became evident that the golf management corporation was a poor operator of the golf course (it took short cuts, let maintenance slip and evidenced a disinterest in the property). At least five years before it did so, the Manager knew that the golf management corporation was going to exercise an early termination option under the sublease. In the Court's opinion, the Manager had plenty of time to take actions that could have turned the property around. The Manager could have searched for a replacement management corporation; explored having the LLC itself manage the golf course; or looked for potential third party buyers for the LLC. Instead, motivated by its belief that the property would be more valuable as a residential community and its desire to rid itself of its minority members, the Manager, by its own actions, allowed the business to fail. It bought the LLC's interests at a sham auction (at which it was the only bidder) at a depressed value and ousted its minority investors at a nominal price.

MANAGER BAD FAITH COURSE OF CONDUCT

The Court outlined the many instances where the Manager did not act in good faith to the detriment of the LLC. As noted above, the Manager was aware the venture was failing and had plenty of time to take corrective steps to preserve the value of the LLC and the property. The Manager never attempted to locate alternate management, and it never actively marketed the property for sale. The Court noted that "a responsible fiduciary…would have searched for a replacement operator…, assessed whether it could modify its business model to operate the course profitably itself or looked for a buyer to acquire [the LLC] or its assets."

When a potential buyer, of its own accord, did come forward with interest in the purchase of the LLC's interest, the Manager actually withheld diligence materials from the prospective buyer and failed to keep the other members adequately informed of the discussions. In fact, the Court found that the Manager withheld relevant information from the other members in order to later justify the Manager's own lowball bid for the property and to make it appear that such a lowball bid was a market offer. When the potential bidder offered $4.15 million for the LLC's interest, its representative also mentioned that it "may have an interest north of $6 million" and that it may be able to get more aggressive with the bidding. The only part of this information relayed to the minority members by the Manager was that there was a $4.15 million offer on the table. The Manager even refused the minority members' request to try and negotiate a higher price. Later, the Manager would point to the $4.15 million amount to justify its own lowball offer to buy the property at $5.6 million.

The Court also pointed out that the Manager hired an inexperienced and inept auctioneer to market and conduct a sham auction for the property allowing the Manager, as sole bidder, to win the auction at only $50,000 over the LLC's debt. The auctioneer marketed the sale for only 90 days prior to the auction. There was no evidence in the record that the auctioneer marketed the sale to anyone within the industry (i.e., golf course brokers, managers or operators) or even to those credible buyers who previously showed interest in the property. Additionally, the Manager retained the right to call off the auction at anytime and for no reason. Consequently, the Manager was the only bidder at auction.

Finally, the Court pointed out that, despite having previously claimed the LLC would not be able to run the course profitably and pay the mortgage, since taking possession of the property at auction, the Manager had run the course itself and was paying the debt.

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Slander of Title: An Old Remedy Revived

By Marvin J. Cine

We are all familiar with the adage, "If you do not have something nice to say, then do not say anything at all." Though this maxim is commonly employed to discourage oral or written invectives, whether on the playground or elsewhere, it is also applicable to real estate transactions. Ordinarily, disparaging remarks are classified as defamation—whether libel or slander—since the attacks are personal in nature. Yet, defamation can also affect one's dominion over property if the statement impugns the condition of the property or the clarity of title.

English and American laws have always favored the unencumbered ability to transfer property rights without the fear of undue delay or litigation. Sometimes, in the worst case scenario, litigation becomes the unfortunate, but inevitable, route to redress injurious, false claims about the property. One means of protection is an action for slander of title, which originated in the late 16th century as a remedy to restore feudal lords' reputation, power, wealth and, most importantly, property rights. Surprising as it may seem, this old remedy is alive and well.

To satisfy the elements of slander of title, the plaintiff must plead and prove that (i) he possessed the estate or interest in the property being disparaged; (ii) the defendant stated or "published" disparaging remarks regarding the property to a third party; (iii) the disparaging words were false; (iv) the disparaging words were malicious in nature; and, finally, (v) the plaintiff incurred special damages as a result of the disparaging remarks. Slander of title claims are rather uncommon; however, they are undergoing a renaissance as land owners increasingly feud with banks, utility companies and even next door neighbors over foreclosure actions, liens and property boundaries, respectively.

The Vermont Supreme Court heard only three cases involving slander of title prior to its April 2011 decision in *Sullivan v. Stear*. In this case, the plaintiff, Anne Sullivan brought a slander of title action against her neighbors, the Stears, on account of the Stears' claim to a private driveway and cul de sac. Sullivan had always believed that this private driveway and cul de sac was a public road, and this belief was eventually confirmed by a Vermont trial court. However, the Stears claimed to have a recorded deed that conveyed the same private driveway and cul de sac to them.

Determining the rights to this private driveway and cul de sac led to Sullivan's slander of title claim against the Stears. Sullivan, who was selling her house at the time, believed that the Stears' claim to have a recorded deed granting them rights to this area would diminish the value of her lot and, basically, make it unsalable. The trial court ruled against Sullivan, and its decision was affirmed on appeal. The court did not consider the diminished value of Sullivan's lot to be the primary issue; rather, the court dismissed her claim on the ground that she did not have an ownership interest in the property or, more specifically, any legally protected interest in the road as it was the property of the town. The Vermont Supreme Court decision underlines the importance of bona fide legal title since Sullivan may have won her claim if she had an ownership interest in the land in dispute.

Slander of title can occur in a variety of ways, including: casting doubt upon the rightful ownership of the title, filing a lien against the title or calling into question the property owner's legal interest in the property. More notably, disparaging comments or published statements that are made with the intent to interfere with a sale fall under the umbrella of slander of title. To illustrate, imagine a scenario wherein a stranger (or a bitter, vengeful neighbor, who is still missing his lawnmower from the seller) tells a prospective buyer that the house is filled with termites two days before closing in hopes of frustrating the sale. After hearing this, the buyer immediately cancels the deal, and the seller is left without any potential buyers. The vindictive neighbor not only intended to deceive the prospective buyer, but he also recklessly made the statement in conscious ignorance of the truth to the harm of the seller. This scenario is ripe for a slander of title action since the neighbor falsely and maliciously attacked the seller's property and killed the deal at the expense of the seller.

Unlike personal slander, which sometimes requires no more than "ordinary negligence" in the publication of the false statement to a third party, "malice" must be proven in a slander of title action. Settling upon the definition of malice can be elusive, yet the majority of courts deem malice to be an evil motive or reckless disregard of the truth. The *Wharton* case decided by the Vermont Supreme Court in 2003 highlights the significance of "malice" within the slander of title action. The facts of the case are as follows.

Tri-State Drilling and Boring drilled a well on the property of the Wharton family, thinking the property was owned by a neighbor who had ordered the well. The Whartons were on

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GOOD NEWS FOR MULTIFAMILY PROPERTY OWNERS, *CONTINUED FROM PAGE 1*

LOAN TERMS: WHAT TO EXPECT

CME Program financing is available for multifamily assets as well as, in certain cases, student housing and senior housing. The typical loan size ranges from $5 million to $100-plus million, and loan terms are primarily five or seven years, although 10-year terms are available. In a few cases, such as the Starrett City refinancing handled by Marty Siroka of Bingham's New York office, significantly larger loans were made under the CME Program. Loans are available at both fixed rates and adjustable rates, with fixed rates being more common. While most loans use a 30-year amortization, partial interest only loans are available (with a slightly higher spread). While Freddie Mac typically requires a minimum debt service coverage ratio and maximum loan to value ratio at closing, it does not require ongoing debt service coverage ratio and LTV covenants. DSCR requirements generally range from 1.15x to 1.40x, with loan to value requirements generally ranging from 60 percent to 80 percent. The LTV and DSCR requirements vary depending on the term (typically more stringent for deals of seven years or more) and amortization of the loan, as well as whether or not the loan is interest only and has a fixed or adjustable rate.

As noted above, most loans under the CME Program provide for yield maintenance until the loan is securitized (typically within the first 12 months), followed by a two-year lockout period with defeasance permitted thereafter. If the loan is not securitized, or if a borrower is willing to pay a slightly higher interest rate, yield maintenance is available. In either case, no prepayment penalty is payable in the final 90 days of the term of the loan.

Borrowers should expect to fund tax and insurance escrows, as well as replacement reserve deposits of not less than $150/unit annually (increasing based on the age and condition of the property). Some borrowers can successfully negotiate a waiver of these escrow and reserve deposits provided they are willing to accept a higher interest rate. In addition, Freddie Mac will require a repair escrow of 125 percent of the estimated costs of any immediate repairs, with repairs typically required to be completed within 90 days of closing.

GETTING IT DONE

From start to finish, borrowers should expect the process of obtaining CME Program financing to take approximately 60 days, although we have certainly seen the process accelerated. Lenders will typically provide a quote within a week, and borrowers are expected to submit a complete application within a week thereafter. A commitment should follow within the next two to three weeks. Ideally, borrowers will rate lock within a week after execution of a commitment and close shortly thereafter. Freddie Mac also offers an Early Rate Lock Program (up to four months) and, in rare cases, an extended Early Rate Lock (up to 12 months). The duration of the Early Rate Lock will be reflected in the spread. All rate locks require a two percent deposit that is refunded at closing. At the time of the rate lock (particularly an Early Rate Lock), the borrower needs to be comfortable that all legal (title, survey, etc.) and underwriting issues have been resolved to Freddie Mac's satisfaction. As with any transaction, timing is highly dependent on the relationship of the parties, the quality of the asset and the complexity of the transaction.

WHO IS THE BORROWER?

Regardless of loan amount, a borrower under the CME Program must be a single asset entity. As the loan size increases, Freddie Mac's requirements with respect to a borrower's organizational structure and operating covenants become stricter. For loans of any size, Freddie Mac requires a special opinion from Delaware counsel with respect to any borrower (and in the case of larger loans, the SPE equity owner discussed below) if such entity is a single member Delaware limited liability company. For loans between $5 million and $25 million, a borrower must be a newly formed, single purpose entity (SPE), although recycled entities (i.e., an existing single asset entity) may be permitted in limited circumstances (typically larger loan amounts or refinancings). As the loan size increases to the $25 million to $50 million range, in addition to requiring an SPE borrower, an SPE equity owner (that owns at least a 0.5 percent interest in borrower) is also required unless borrower is a corporation or a single member limited liability company. For loans of this size, Freddie Mac also requires a non-consolidation legal opinion. Limited liability company or corporate borrowers and SPE equity owners are also required to have one independent manager or director. Finally, "springing member" provisions must also be incorporated into borrower's organizational documents to protect the lender against a bankruptcy or removal of the borrower's member. For loans in excess of $50 million, all of the foregoing requirements are applicable, and, in addition, all limited liability company or corporate borrowers or SPE equity owners are required to have two independent managers or directors. Negotiation of the

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BAD BOY GUARANTEES, *CONTINUED FROM PAGE 2*

by the parties to the original loan negotiations. Others have pointed out that in transactions between sophisticated parties the courts have always been reluctant to go beyond the express wording of loan documents. They also note that CMBS pool trustees have a fiduciary obligation to enforce the literal terms of documents securing pool loans.

The reaction to these Michigan decisions was dramatic. Early this year a bill was introduced in the Michigan legislature intended to reverse their results. The bill was quickly passed by the Senate and House and was signed by the governor in March. The legislation applies to nonrecourse commercial loans secured by a mortgage on real property located in Michigan. It prohibits use of a "post closing solvency covenant" as a nonrecourse carve out against a borrower or guarantor and states that any provision in the documents for a nonrecourse loan that does not comply with this prohibition is invalid and unenforceable. It further states that it applies to the enforcement and interpretation of all nonrecourse loan documents in existence on, or entered into on or after, the effective date of the act.

There are two principal problems with this legislation. First, loan documents for most larger transactions include a "bifurcated" choice of law. While the mortgage will be governed in whole or in part by the law of the state where the property is located, the note and guaranty in larger transactions are usually governed by New York law. The guaranty often also contains a "choice of forum" clause permitting suit for its enforcement to be brought in New York. Bringing suit in New York for enforcement of the guaranty may avoid the risk that a Michigan court could refuse to apply New York law on public policy grounds. The second problem is with the provision applying the legislation to loan documents in existence on the effective date of the act. Article 1 Section 10 of the United States Constitution provides that "No State shall…pass any Law… impairing the Obligation of contracts…." A similar provision appears in Article 1 Section 10 of the Michigan Constitution.

Loan document provisions similar to those involved in the *Cherryland* and *Chesterfield* cases exist in hundreds of billions of dollars worth of CMBS loans and other commercial real estate loans. At the present time the decline in commercial real estate values resulting from the recent financial crash has rendered many borrowers technically insolvent. As a result, these decisions are of critical importance to the real estate industry. It remains to be seen how these decisions will fare on appeal and how the issues will be resolved in decisions by courts in other states. <

CIRCUMVENTING THE SECURED LENDER'S RIGHT TO CREDIT BID,
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require all transfers to gain the benefit of the Section 363 procedures and its commensurate right to credit bid.

In re Philadelphia Newspapers came to a similar conclusion. Collateral was sold in an auction format with an affiliate of shareholders of the debtors being the "stalking horse" bidder for the assets. The plan called for a portion of the proceeds to be delivered to the secured lenders together with additional realty. The court affirmatively barred the secured lenders from credit bidding, finding that the sale was not conducted under Section 363 of the Bankruptcy Code, and the "indubitable equivalent" alternative for a "fair and equitable" return to the secured lender did not expressly provide for a right to credit bid.

Riding to the rescue (from the secured lender's perspective) was the 7th Circuit Court of Appeals in its 2011 decision *In re: River Road Hotel Partners LLC*. The debtor wanted to schedule an auction for the debtors' assets involving a "stalking horse" bidder and attempted to bar the secured lenders from credit bidding. The district bankruptcy court found the dissent of Judge Ambro in the *Philadelphia Newspapers* case persuasive, and the Court of Appeals affirmed, holding that this scenario was an impermissible evasion of the credit bid protections typically enjoyed by secured lenders.

Interestingly, each of the Circuit Courts of Appeals claimed to be interpreting the applicable statute using the classical canons of statutory construction. The U.S. Supreme Court has agreed to decide this issue in 2012.

In another case heard by the 7th Circuit Court of Appeals, *In re: River East Plaza*, the debtor again tried to use the "indubitable equivalent" alternative as an end-around another secured lender protection.

By way of background, if a lender with a secured claim is undersecured (i.e., if its collateral value has dropped below the amount of indebtedness owing to it), the secured creditor typically has two claims—a secured claim in the amount of the collateral value and an unsecured claim for the balance of the obligations owing to it. But the undersecured creditor can make an "1111(b) election," named after the corresponding section of the Bankruptcy Code. This election allows the undersecured creditor to treat the entire claim as a secured claim and still retain the benefit of the three "fair and equitable" protections. The undersecured creditor will retain its full lien on the collateral; any payments it receives under a plan of reorganization approved over its objection cannot have a present value in excess of the collateral value. But if it believes the collateral valuation is too low, or if it believes the borrower is going to default or end up in bankruptcy again in the near future, then it might behoove the undersecured lender to make the 1111(b) election.

In the *River East Plaza* case, the undersecured lender made the 1111(b) election, effectively signaling its determination that its collateral was undervalued. The debtors attempted to discharge the lender's lien on the real estate and offer "indubitable equivalent" collateral in the form of U.S. Treasuries, which, over 25 years, would return the full $38.3 million owed to the lender. The debtors argued that this was "indubitable equivalent" collateral because the lender would retain the full amount of its claim and enjoy the perceived safety of U.S. Treasuries.

The secured lender objected, arguing that the proposed "indubitable equivalent" collateral would be tantamount to an end-around its right to avail itself of the 1111(b) election—the secured lender would not enjoy the benefit it perceived by retaining its full lien on an undervalued asset. The court agreed with the secured lender, finding that the debtors could not avoid the secured lender's 1111(b) election by offering substitute collateral that bore a different risk profile than the real estate collateral, itself. The court focused on the fact that the secured lender could enjoy significant upside to its decision should the property appreciate in value and the fact that the secured lender might lose out should the property continue to depreciate. The court did not perceive the relative safety of U.S. Treasuries as having the same risk-reward profile as the realty.

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The fundamental business model for nonrecourse real estate financing is that if something goes wrong, the lender gets the property. Bankruptcy has always been one way to undermine this fundamental structure. This new trend represents bankrupt property owners' attempt to skew it further.

A nonrecourse mortgage lender regularly gets the benefit of its bargain by either getting the value of the property or acquiring the property by credit bidding in a state foreclosure sale. The lender's remedial interest in the property's upside (or downside) is the basis of the original bargain.

Utilizing the "indubitable equivalent" alternative as a tactic to override a lender's right to credit bid or to try to strip the lender of its opportunity to bet on an undervaluation puts a thumb on the scale further in favor of the bankrupt borrower and further undermines the nonrecourse financing structure. Indubitably. <

LLC MANAGERS BEWARE, *CONTINUED FROM PAGE 4*

COURT'S FINDINGS OF FIDUCIARY DUTIES

The Manager argued that its voting power gave it license to exploit the minority members. The Court noted that the problem was that the Manager itself created a situation of distress by failing to cause the LLC to explore its market alternatives and then bought the LLC for a nominal price. The Manager wanted the management of the property to fail. The Court stated that "the purpose of the duty of loyalty is in large measure to prevent the exploitation by a fiduciary of his self-interest to the disadvantage of the minority."

The Court also disagreed with the Manager's argument that its actions were not subject to any fiduciary duty due to the terms of the LLC's operating agreement. The Court pointed out that "the rules of equity apply on the LLC context by statutory mandate, creating an even stronger justification for application of fiduciary duties grounded in equity to managers of LLCs to the extent that such duties have not been altered or eliminated under the relevant LLC agreement."

As further support for this conclusion, the Court noted that the Delaware Limited Liability Company Act expressly permits the elimination of fiduciary duties in an LLC agreement. The Court pointed out that it is only logical that something must first exist in order for someone to be able to eliminate it. The Court hinted that a simple phrase stating that the only duties owed by the Manager to the LLC and its investors are set forth in the agreement itself would probably have been sufficient to displace the traditional fiduciary duties of loyalty and care owed to the company and its members by the Manager. This LLC agreement, in particular, did not contain such language.

The LLC agreement did, however, contain both a "fair deal price" and an exculpatory provision. Unfortunately for the Manager, the Court found that the Manager also failed to meet the requirements of either of those provisions because of the Manager's bad faith actions.

Under the "fair deal price" provision, the LLC could enter into transactions with affiliates provided the transaction met an arms-length third party standard of dealing. The Court noted that the Manager failed to meet this standard because it never truly tested the market for the true worth of the LLC. The Manager never really entertained potential bidders to assess true value, and it conducted a sham auction. Based on these bad faith actions, the Court noted: "Where a self-dealing transaction does not result from real bargaining, where there has been no real market test, and where the self-interest party's own conduct may have compromised the value of the asset in question of the information available to assess that value, these factors bear directly on whether the interested party can show that it paid a fair price." The Court found it most important that the Manager itself was responsible for any evidentiary uncertainty with respect to the true value, which was caused by the Manager's own disloyalty: "It was [its] own selfishly motivated acts of mismanagement that led to the distress sale."

The operating agreement of the LLC contained an exculpatory provision that would have allowed the Manager to escape monetary liability for its breach of its fiduciary duties if it could prove that its breach was not in bad faith or the result of gross negligence, willful misconduct or willful misrepresentation. The exculpatory provision also insulated the Manager from liability for authorized actions. The Court noted that this exculpatory provision did not shield the Manager from its liabilities (1) because, as outlined above, the Manager did not act in good faith and (2) because of the failure to buy the LLC at a fair price, the Manager did not take an authorized action when it bought the LLC at auction.

The Manager had no duty to sell the LLC interests, but it could not, through its own bad faith actions, mismanage the LLC so as to deliver the property to itself at an unfair price.

CONCLUSION

The result of this ruling is that, absent express provisions to the contrary, fiduciary duties are implicit in Delaware LLC agreements. Even if a manager has complete voting power and may make or not make strategic decisions in its sole discretion, it will be subject to fiduciary obligations inherent in the operating agreement and owe a duty of loyalty to its minority members.

It is interesting to note that the Delaware Limited Liability Company Act permits full contractual exculpation for breaches of fiduciary and contractual duties, but it prohibits the elimination of the implied contractual covenant of good faith and fair dealing. In this case, although the Court's ruling was based upon the Manager's breach of its fiduciary duties of loyalty and care, every justification the Court provided for its findings was related to a "bad faith" act of the Manager. The opinion is replete with examples of what the Court considered to be Manager's "bad faith" actions. Therefore, even if the LLC's operating agreement had contained an express elimination of all fiduciary duties, it is quite possible that the Court still would have found the Manager culpable for violating its implied contractual covenant of good faith and fair dealing, which may never be contractually eliminated under the Delaware Limited Liability Company Act. <

GOOD NEWS FOR MULTIFAMILY PROPERTY OWNERS, *CONTINUED FROM PAGE 6*

required structure of the borrower as well as the preparation of organizational documents that mirror the special purpose entity requirements of the loan documents can be costly and time-consuming. As such, borrowers and their counsel should work with lenders early to establish requirements and obtain signoff on documentation.

WHO'S GOT YOUR BACK?

Borrowers will be required to arrange for a deep pocket to execute a recourse carve-out guaranty. The loans are generally otherwise non-recourse. While the recourse carve-outs under the CME Program are relatively standard, they are slightly more restrictive than under Freddie Mac's conventional mortgage program. The loans become full recourse to the guarantor in the following events: borrower's failure to comply with the SPE covenants (with certain exceptions); any voluntary bankruptcy filings of borrower or any SPE equity owner; any involuntary bankruptcy filing if borrower or its SPE equity owner failed to use commercially reasonable efforts to dismiss the proceeding or consented to the proceeding; and a prohibited transfer of the property or of the ownership interests in the borrower. Unlike Fannie Mae financings, the CME guaranty (like the Freddie Mac portfolio guaranty) also covers environmental matters. While there is some limited room for negotiation of the standard recourse carve-outs, any negotiations should be tackled as early in the loan process as possible. In addition, in light of recent litigation in Michigan (which is described in more detail in Henry Healy's article), borrowers and guarantors (and their counsel) should be particularly diligent in negotiating recourse carve-outs with respect to the SPE covenants.

WRAPPING IT UP

The availability of funds and the favorable terms associated with the Freddie Mac CME Program make it a very attractive option for many multifamily property owners. Then again, it's not for everyone.

Among the keys to successfully closing a CME Program financing are: communicating early and often with the lender and its counsel, setting realistic expectations on your ability to negotiate the documents (if you are hell-bent on adding "reasonable" and "material" throughout documents, this may not be the program for you), and recognizing that deviations from the standard CME Program will probably result in higher rates. <

SLANDER OF TITLE, *CONTINUED FROM PAGE 5*

vacation at the time. Upon returning home and seeing the well, the Whartons informed the Tri-State employees, who were still on the premises, that they would not pay for the well. At this point, Tri-State asked the Whartons for an easement so that the neighbors could access the well. The Whartons denied this request in fear that the easement would hinder their ability to sell the house. Tri-State then filed a mechanic's lien against the Whartons' property for the cost of the well. Despite the fact that the Whartons informed Tri-State that it had drilled the well on the wrong lot, Tri-State unwaveringly refused to remove the lien.

In August of that same year, the Whartons attempted to sell their house. They found a prospective buyer and were on the brink of closing the deal; however, the buyer backed out once the mechanic's lien came to light in the title search. The Whartons, thereafter, filed suit claiming that the mechanic's lien was slander of title. The trial court ruled in favor of the Whartons intimating that the mechanic's lien was falsely published, done with malice and led to a lost sale. This decision was later affirmed on appeal in the Vermont Supreme Court. The court rested its decision on Tri-State's admission of filing the lien for the sole purpose of pressuring the Whartons to grant the easement. Thus, Tri-State's conduct was found to be in reckless disregard of the truth and, therefore, malicious.

As a general rule, slander of title can be avoided by sticking to factual information, confirming title through an independent search, and only filing liens when there is proper reason and legal justification to do so. As Oliver Wendell Holmes wrote, "Possession of something which you have enjoyed and used as your own for a long time, whether property or an opinion, takes root in your being and cannot be torn away without your resenting the act and trying to defend yourself." The slander of title claim serves as the shield defending the rights of the owner and, more importantly, the reputation of the property. <


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