



## THE GREAT FLUSH

### *SURPRISE, SURPRISE, SURPRISE*

The big surprise of the current downturn is prevalent use of note sales rather than traditional foreclosure. While discounts can be steep, the turnaround from bad loan to cash can be quick, and there is no management hassle for the financial institution holding the asset. There seems to be some settling in the marketplace with current pricing on note sales rising above the bargain basement lows seen last year.



The other big surprise is the rush to the courthouse with suits on notes and guarantees rather than to the courthouse steps for foreclosure. This practice was rare in past downturns, but appears to be prevalent, if not primary, this time around, putting maximum pressure on the individual principals with hopes of inducing a cash influx.

Georgia foreclosure is relatively simple, being non-judicial, which is attractive to lenders. A Georgia foreclosure can be accomplished in 45—60 days, compared to a judicial jurisdiction like Florida in which foreclosure can take 6 months or more. Georgia law allows pursuit of guarantors following foreclosure after “confirmation” of the foreclosure sale, which validates the procedural aspects of the foreclosure as well as the value of the foreclosed asset. Any deficiency in the foreclosed value and the loan amount can then be sought from the borrower or any guarantor.

However, the use of the note and guaranty lawsuit as a remedy of first instance ostensibly allows the lender to obtain the judgment first, offset the judgment with the presumed value of the secured property (without judicial confirmation), and attach other assets of the borrower and guarantors to satisfy the deficiency.

A recent case sought Georgia Supreme Court review of this practice of suing first on the note and guaranty as potentially an attempt to circumvent the foreclosure confirmation statute, but review was denied, perhaps because the lender had not yet foreclosed, meaning that the issue was not yet “ripe” for judicial review.

When the note has been sold, some note purchasers have no intention of foreclosing, and instead use the note and guaranty suit to put maximum pressure on the borrower to create leverage for a negotiated payout or settlement. In this environment, there is no established path of peace or resistance, and borrowers should beware of anyone offering quick advice on how to escape. It seems as if the wild west has moved to Georgia.

### SHORT SALES

The short sale is the sale of the secured asset for less than the loan balance. This requires advance approval of the lender, who may accept a reduced payoff in exchange for a quick resolution. Additional cash or security may be required of the borrower as a condition precedent towards obtaining lender approval.

The retribution motif is still evident in the short sale, most lenders being reluctant to allow a borrower to benefit from the reduced bargain. Therefore, any attachment of the borrower, or of any family members, affiliates or friends to the property, in the form of an occupancy, lease or other interest, following the short sale is resisted. The purchaser will be required to sign an affidavit of no relationship with the borrower, upon which the lender relies, and a false affidavit would make the affiant liable to the lender for the difference between the short sale price and the loan amount.

Some borrowers may be asked to give promissory notes for the deficiency, payable over a period of years, with little or not payments due initially. The value of these “wish notes” is yet to be determined.

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## Note Sales and the Rush to Liquidity

A PROMISSORY  
NOTE IS DEFINITELY  
WORTH MORE THAN  
THE PAPER IT'S  
WRITTEN ON



THE MONEY STORE  
NEEDS MONEY!

At the beginning of this downturn, some financial institutions saw which way the winds were turning and commenced a wholesale purging of their real estate loan assets. Electronic marketplaces, like DtechX, facilitated transferability by allowing for online storage of loan documentation and due diligence, with secure registration and bundling of assets.

One complication was the volume of assets available for purchase, including those from failed financial institutions. The initial reaction of lenders was to turn away from the most motivated source for liquidity, the existing borrower. Loans were bundled together to prevent a borrower from purchasing its own loan at a discount. Only bundled purchases were permitted.

Institutionally-based and capitalized purchasers appeared, making direct contact with lenders holding paper. Loan losses could be quickly mitigated by the liquidity afforded from the note sale, which is generally a much shorter period than would be the case with a foreclosure, followed by period of REO asset management and sale of the asset.

Technically, the note sale is not overly complicated. The transactions tend to be “as is, where is” with no representations by the seller other than it is the holder of the paper and the outstanding balance of the loan. Review periods tend to be short, as with REO sales.

The transfer is effected with an endorsement on

the face of the note, or with an *allonge* which is attached to the note. A recordable transfer and assignment of the security deed and other loan documents should be filed, and cross-indexed, in the appropriate public records. A secondary, unrecorded, blanket assignment is also advisable. UCC financing statements should be amended and updated to reflect the assignee as the secured party.

Title should be checked down to the date of closing, with a title company issuing an endorsement reflecting the assignment of the security deed and perhaps updating the effective date of the policy.

The bankruptcy of the borrowing entity is a real risk that cannot be avoided, but recent amendments to the bankruptcy code regarding single asset real estate bankruptcies make bankruptcy more of a hassle than a complete hindrance, since many real estate loans are made to single asset entities. A word of caution is in order in light of bankruptcies like *General Growth*, wherein the court effectively allowed consolidation despite very specific single purpose entity language in the governing documents of the borrowing entities and in the loan documentation.

The conduct of the parties leading up to the note sale can be critical. A prudent purchaser would want the right to speak with the borrower to determine if there are any hidden issues. Lender liability claims may attach to the documents, even if spurious, which could complicate

collection efforts. Even existing litigation may not be disclosed by a public records search, particularly if the named parties are not identical with the borrower. We have heard of an instance in which a partner of the borrower, who was also a guarantor, made threats of suing the lender for misapplication of repaid loan funds from another transaction. Had the loan funds been applied to the guaranteed loan, the partner/guarantor’s liability would have been reduced. The threat of litigation was enough to induce the note purchaser to settle the case before it went to court to avoid the litigation costs.

Another potential hidden risk is if the seller of the paper has granted a security interest in the paper to its lender. There are lenders that finance note purchases with general security agreements and collateral assignments of loan documents. These may not be of public record. A release from the collateralized lender is absolutely necessary in such circumstances.

Finally, pay attention to the status of the loan. Look for copies of default letters, with evidence of receipt by the borrower. Most loans require a borrower to provide an estoppel as to the loan status, but getting cooperation at a time of loan default and pending note sale is not likely.

The note sale is one of several liquidity raising tools in the lender’s toolbox, and has the advantage of raising quick cash with little administrative or managerial headache.

## *The Role of the Receiver*



### GIVING UP CONTROL

With the growing list of distressed real estate on the books of banks, lenders are deciding whether to renegotiate the loans, selling the note to a third party or foreclosing on the property that is securing the loan. Many times, the decision as to how to proceed will be based on the estimated value of the property and the potential ability to increase the value of the asset to protect the value of the loan. If the property has potential value, it is very likely that the bank will opt to enforce its rights under the loan documents to appoint a receiver to take over the operation of the real estate enterprise. Through a receiver, the bank can take control of the asset, both physically and financially. If the borrower does not consent to the takeover of the receiver, a motion will need to be filed asking the court to intervene and impose an order for the appointment.

Many times the appointment is a foregone conclusion. However, if the borrower still

believes that it can maintain the asset and hopes to weather the storm, the borrower can challenge the appointment of a receiver. It is not an easy process, but possible if the lender has not met all of the requirements under the note to declare a default (such as proper notice). Further, the law requires that the petitioning lender demonstrate that there is a risk to the property should a receiver not be appointed. Should the lender fail to meet the conditions precedent for an appointment of a receiver, at best the borrower can buy some time to seek a remedy to its financial woes before the lender re-files and ultimately accomplishes its take over of the asset.

There are two types of receivers, a general (or liquidating) receiver and a special receiver. The general receiver controls all the assets of the debtor and determines whether to sell or liquidate the assets of the business in order to pay creditors. The special receiver only has power over specific assets. A receiver can be either an individual or a company. However, it is advisable that the receiver have specialized knowledge and experience concerning the asset or assets involved. Also, sometimes the court will require that a bond be posted during receivership (to protect the interests of the

borrower). Once the receiver is in place, the receiver takes control over all operations (including leasing). Additionally, the receiver also begins the process of determining if the asset can be sold (which the receiver has the power to decide) or whether foreclosure is the best option. All of these powers should be specifically outlined in the Receiver Order. The Order should make clear what rights and powers, if any, are retained by the owners of the business. However, even while in receivership, the borrower remains liable and during this period, the borrower and lender can still negotiate a workout and renegotiation of the loan.

Finally, the receiver is generally responsible for submitting regular reports to the Court to keep the court and others informed of the progress. The reports can also include expected actions to be taken by the receiver concerning the asset. The goal of these reports that include future plans are to identify in advance any objections that may arise by the borrower or other creditors.

THERE ARE TWO TYPES OF RECEIVERS, A GENERAL (OR LIQUIDATING) RECEIVER AND A SPECIAL RECEIVER.



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WE AT WEISSMANN ZUCKER EUSTER MOROCHNIK P.C. ARE COMMITTED TO PROVIDING VALUE TO OUR CLIENTS. TO US, "VALUE" IS NOT JUST A WORD, BUT A PHILOSOPHY. IT MEANS OFFERING EFFECTIVE LEGAL SERVICES THAT RESPOND TO OUR CLIENTS' NEEDS IN A PROMPT, COURTEOUS AND ATTENTIVE MANNER AND IT MEANS FULFILLING THE HIGHEST STANDARDS OF OUR PROFESSION.

### *Insurance—Reservation of Rights Letters*

Due to some recent cases decided around the country, property and business owners need to take a new look at their insurance policies to see what coverage they have – or don't have when it comes to their insurer's obligation to defend claims brought by third parties. Additionally, these companies need to review the rights of their insurance carriers to recoup any costs that are incurred in defending the claims if later it turns out that coverage was not required. The cases of Valley Forge Insurance Company v. Health Care Management Partners, Ltd (10<sup>th</sup> Cir. 2010), Zurich American Insurance Co. v. Public Storage (E.D. Va. 2010) and American & Foreign Ins. Co. v. Jerry's Sport Center (Pa. 2010) all involve actions by insurers who brought declaratory judgment actions challenging their coverage obligations on certain third party claims. In each, the court concluded that coverage was not included within the policies and the insurers were released from their defense obligations. However, by the time the rulings had been made, the insurance companies had already incurred significant costs of defense. The insurers in these cases sought "recoupment" of their costs based on the contention that they never had the duty to insure. Further, each brought to the court's attention that they had submitted to their insureds a reservation of rights letter which notified the insured that, notwithstanding their defense, that they reserved the right to challenge coverage. Only in the Valley Forge case did the court permit recoupment. One of the significant points in that decision was that the insured received a reservation of rights letter which gave notice of a possible claim of recoupment and the insured submitted no response and no objection.

There are two significant lessons for property and business owners as a result of these decisions. The first is that insureds should inquire with their insurance carriers to verify their coverages. Second, owners can no longer ignore the standard "reservation of rights" letter that they may receive from their insurance companies in the midst of a claim. Based on these cases, it is important to respond to those notices, at least for the purpose of stating an objection to the letter, especially if the letter references a right to recoup defense costs.