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Trends in Hotel Transactions

An Increasingly Hospitable Environment for Hospitality Transactions

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The recent announcement by Loews Hotels & Resorts of the development of a new 1,800-room resort at Universal Orlando is the latest in a series of significant hotel transactions taking place in Central Florida over the course of the past several years as hotel developers and operators have sought to take advantage of favorable financing terms, low construction costs, and a variety of pro-development initiatives during the economic recession.

These significant local projects, and similar transactions throughout the United States, serve to highlight a hospitality industry that appears to be poised for significant growth as the real estate market continues to recover.

The following trends are particularly relevant in today's hospitality market:

Portfolio Acquisitions

The current market has given rise to an increasing number of portfolio acquisitions, as real estate investment trusts and other institutional real estate investors seek to sell several hotel properties in a consolidated transaction, often in an effort to offset an attractive property with one or several underperforming properties, and to prevent a buyer from "cherry picking" the most attractive assets comprising a portfolio.

Although portfolio transactions can result in added complexity, buyers of hotel properties can often exert a greater degree of leverage in helping institutional sellers dispose of underperforming assets.

"Boutique" Management Companies

Apart from the traditional names in the hotel management business — including Marriott, Hilton and Starwood — on the rise in today's hospitality market are many smaller "boutique" management companies that accept a shorter management agreement term and may offer increased flexibility and creative fee structures relative to the traditional hotel management model.

Flexible Financing Terms

Lending institutions are offering hotel acquisition and development loans on more attractive terms.

Buyers are also taking advantage of the opportunity to assume and/or refinance the seller's existing financing as an

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alternative to new mortgage financing.

Even in situations where acquisition or development financing may not be readily available, hotel owners are nevertheless demonstrating confidence in the market by pursuing alternative sources of capital to facilitate the renovation, refurbishment and expansion of existing properties.

New Marketing Initiatives

Hotel operators will continue to differentiate their properties in an increasingly competitive market through innovative social media campaigns, creative rewards programs, concierge services and mobile booking options.

One cautionary note: increased targeted marketing raises numerous privacy issues, and hoteliers are advised to be well aware of the intricate legalities in that arena.

Traditional Issues

Apart from the key trends in today's hospitality market, several critical issues remain relevant in hotel transactions, including the following:

Post-Closing Indemnification

Buyers need to be aware of the potential risks associated with buying a hotel property from a "special purpose entity" (SPE), whose only assets may be the property that is the subject of the transaction.

As a result, when dealing with SPEs, in particular, buyers should negotiate for either (a) a guaranty from the seller's "parent" entity, or a related entity with verifiable assets, or (b) the escrow of a portion of the closing proceeds until the period for indemnification under the applicable purchase and sale agreement has expired.

Liquor License Issues

Liquor license laws vary significantly from state to state, and the failure to comply can result in a failed closing condition (if the liquor license cannot be obtained prior to the closing date), the revocation of an existing beverage license, potentially significant fines, and/or a lapse in beverage service to patrons of the hotel.

Buyers should engage a liquor license consultant or an attorney with experience dealing with the state and local liquor license laws as part of their transaction team.

Intellectual Property Issues

Many resort properties include a restaurant, spa, or golf club that operates under a well-known name.

Buyers need to be careful to specifically negotiate for the acquisition of these significant intellectual property rights, and to properly memorialize and register the conveyance of these rights at closing.

Employment Issues

The acquisition of an existing hotel, which often includes the negotiation of a new management agreement, presents unique employment law issues, as employees are frequently terminated by the seller and then immediately re-hired by the buyer.

Buyers must be aware of potential employment law issues and tailor the turnover of the hotel accordingly.

Compliance with The Worker Adjustment and Retraining Notification (WARN) Act should be addressed as part of the negotiation of the applicable purchase and sale agreement.

The acquisition or development of a hotel property can be a very sophisticated transaction with many complex issues.

This article is intended to provide an overview of several key trends in the hospitality industry, and should not be viewed as a comprehensive analysis. Please do not hesitate to contact us with any questions regarding the issues described above, or any other questions that you may have regarding the hospitality industry.

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Our Hospitality & Leisure Group has represented buyers and sellers of a variety of sophisticated hotel properties throughout the United States. For more information on the firm's Hospitality & Leisure Group, please visit: http://bit.ly/ZICJCr

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Document Automation Can Improve Commercial Real Estate Transactions©*

By: Katheryne L. Zelenock, Dickinson Wright PLLC

Residential real estate practice, particularly residential mortgage lending, has long made use of document automation to assure quick, accurate preparation of transaction documents, but commercial real estate practice has been slow to adopt similar solutions.

In part, the difference arises from the assumption that commercial real estate transactions are too complicated to benefit from technology-based drafting.

While almost all residential mortgage lenders use the same Fannie Mae and Freddie Mac forms, for example, commercial mortgage lenders frequently develop their own unique loan documents.

Similarly, while residential leases typically contain only a few variables, commercial leases involve more complicated terms, and a great deal more negotiation — making automation of documents seem unlikely, if not impossible.

The Cut and Paste Problem

Unfortunately, the persistent use of "cut and paste" drafting of commercial real estate transaction documents may be causing drafting delays and costly increases in turnaround time, as well as inadvertent errors in documentation.

"Cut and paste" — the traditional method of marking up a form document, having an administrative assistant make changes, then reviewing those changes — is slower, less accurate, and extremely dependent upon personnel familiar with the intricacies of the form documents.

When many different form documents are maintained, with a large number of inserts or standard and non-standard modifications available, the odds of correctly handcrafting the documents is low — particularly if the instructions for assembly are

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misunderstood by an administrative assistant or associate who is pinch-hitting for the paralegal familiar with the form or the absent senior attorney who better understands the interaction between various document provisions.

Even in the hands of experienced users, cut-and-paste assembly of form loan documents can take hours of work and review by two or three team members — an inefficient (and costly) process.

In an industry that measures the cost of a day's delay in tenant occupancy due to ongoing lease negotiations, or impatiently awaits "locking in" an interest rate until the loan documents have been fully negotiated, the passage of time literally "is" money.

Automation Can Improve the Process

Good document automation systems, whether developed internally, or by deploying a number of solid technological solutions in the market, can speed the process, making drafts and the preparation of the final transaction documents more accurate, and eliminating delays associated with the unavailability of key personnel.

Document automation also speeds preparation of supporting correspondence, checklists, and other documentation, as well as transaction summaries and other reports, carrying the transaction forward at a brisker pace, and decreasing the amount of time that must be spent post-closing to summarize the transaction.

Intelligent document automation is not limited to merely filling in blanks, or even the substitution of entire paragraphs or completion of "if-then-else" statements. Good document automation should fully automate sentence structure word-by-word, taking into account all potential variables, including logic-driven interaction among multiple variables as needed to permit "first-time-final" drafting. With today's technology, all of this and more can be at your fingertips.

Really effective document automation works through multiple rounds of negotiation, automating not only the first draft, but subsequent "punches and counterpunches" as the transaction progresses.

The borrower wants more expansive rights to transfer ownership of the borrowing entity, and the lender's form "playbook" has provisions for that, but those changes affect two different parts of the document? It can — and should be — automated. Do those changes require an adjustment to the paragraph numbering? That should be automated, too.

Effectively, good document automation integrates all of a property owner's, lender's, or landlord's standard templates and routine document modifications so that virtually anyone can assemble the documents when they have the right background information or data.

That's not to say that review of the draft documents is never

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necessary — but that the review is much more efficient, and concentrates on unique situations that cannot be efficiently automated and, therefore, really warrant review.

If your team is still handcrafting custom language and performing laborious word-by-word reviews for your documents — or automating only the "fill-in-the-blank" provisions and handcrafting changes from there — you're coming up short!

Most commercial real estate transactions can be automated to a much greater extent than you initially realize.

It Can Work for Complicated, Highly-Negotiated Transactions

You may be thinking "but our transactions are extremely complicated or highly-negotiated … surely document automation cannot work for those transactions — or will only work for a good first draft, and no further."

Everyone likes to think that their work is so challenging that only highly-qualified professionals can perform it — that it could not possibly be done by a machine.

But by committing your business rules and documents to an automated process, you're actually assuring that your best language appears in your documents without exception, rather than hoping you can avoid the inevitable human error.

Admittedly, document automation at first is only as good as your standard playbook of templates and document modifications. If you don't have tightly crafted templates and a well-organized catalog of "gives," it may take some time to fully automate your documents so that they can be assembled automatically through several rounds of negotiation. But taking the first step to automate the easy stuff will naturally lead to automated drafting of the more challenging items. It's an iterative process — second and third-round negotiated comments are automated once basic provisions are integrated into the system.

It may be true that your initial efforts at document automation are most useful for more straightforward form documents, but with the proper tools, you will quickly advance to much more complicated documents.

Once you start relying on automation, you'll never want to draft the same solution more than once. When you create a new document provision, it will be automated for each future instance in which similar circumstances arise. Imagine receiving pages of comments to the draft loan documents — and being able to provide an extensive redlined draft that responds to those comments (integrating all of your best practices) the same afternoon, without hours of custom drafting!

Roadmap to Automated Documents

Virtually every document automation system — even very rudimentary ones — recognize that simple fields such as the parties' names, property address and other property attributes, and basic financial terms (loan amount, monthly lease payment, etc.) should be automated.

At a more advanced level, you might automate those initial provisions so that unknown information is handled by delivering appropriate placeholders to the document (e.g., blanks, a "to be determined" message, or an error message indicating that a draft should not go out until certain information is added), and add provisions related to a particular state or property use (for example, adding your "Texas Inserts" and "Specialty Use Inserts").

In a more advanced program, document automation enables users to easily take into account any combination of facts, circumstances and/or rules, such as specialized language for particular property types or transaction sizes, state-specific rules, drafting related to a particular customer or property, or any combination of those.

Ideally, deeply embedded logical dependencies can be quickly created, managed and audited by users, for any data element or combination of elements. For example, precisely correct language might be tailored to reflect required or negotiated conditions (e.g., identified repair or build-out needs, special co-tenancy, termination or assignment provisions, or limitations on recourse).

Similarly, documents should be easily automated to recognize any type or combinations of borrower or guarantor entities (corporation vs. LLC vs. other entity types), special provisions for a particular borrower, or thousands of other unique fact patterns, legal

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Collection of Default Interest and Late Charges in Connection with Real Estate Loans

By: Jack Murray, Vice President-Special Counsel, First American Title Insurance Company

Mortgage lenders customarily charge borrowers additional interest upon default, based on a percentage increase in the contract interest rate. In addition, they usually charge borrowers a fee for late payment of installments on the note, often based on a flat percentage of the payment if not made on the payment date or within a specified period of time thereafter.

Federal and state case law is not consistent with respect to the issue of whether these charges and fees are enforceable, i.e., should they be enforceable only if they are justifiable based on the mortgagee's actual or reasonably anticipated costs — or should they not be subjected to this, or any other, test as long as they are entered into by experienced and sophisticated parties in connection with commercial real-estate loans?

Although late charges and default interest are generally upheld by both state and federal courts in connection with commercial mortgage loan transactions and are entitled to a presumption of validity, they are occasionally disallowed in whole or in part under one or more of the following theories: 1) usurious additional interest; 2) invalid penalty; 3) unreasonableness; 4) unconscionability; and 5) unenforceable liquidated damages.

Unfortunately, the case law is conflicting and contradictory and fails to provide clear guidelines for the imposition and calculation of such charges and fees. As a result, this creates a certain amount of confusion and uncertainty. See, e.g., Crawforth v. Ajax Enterprises, LLC (In re Pheasant Cove, LLC), 2008 WL 187529 (Bankr. D. Idaho, Jan. 18, 2008), at *3 (describing "the lack of uniformity in the treatment of default interest provisions, which some courts evaluate under liquidated damages law and others under state usury laws").

But the majority of courts realize that it is difficult for the lender to precisely calculate or quantify the exact costs incurred as a result of the borrower's default, and they tend to look at what is common within the industry (especially in connection with commercial real estate mortgage loans).

For a general discussion of cases on this topic, see Grant S. Nelson and Dale A. Whitman, Late Payment Charges and Default Interest – Judicial Interpretation, 1 REAL ESTATE FINANCE LAW § 6.9 (updated July 2010). See also Baxter Dunaway, Acceleration of Debt, 2 L. DISTRESSED REAL EST. § 15:7 (updated June 2012) ("As a general rule, courts have upheld the right of the lender to accelerate in spite of borrowers' arguments that acceleration acts as a penalty and despite a borrower's good faith effort to avoid default").

With respect to the collection of default interest and other fees or charges in connection with mortgage loans where the borrower is in bankruptcy, Section 506(b) of the Bankruptcy Code provides that if a creditor is oversecured it may be allowed a claim against the bankruptcy estate only if the fee is reasonable — which allows a bankruptcy court to disallow a late fee or default interest even if it is otherwise allowable under applicable state law. Also, in construing the lender's claim for default interest if a bankruptcy proceeding is filed by or against the borrower, § 502 of the Bankruptcy Code generally allows a claim for pre-petition interest, including interest at the default rate if provided for in the parties' agreement, in accordance with the terms of the contract. See In re South Side House,

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LLC, 451 B.R. 248, 264 (Bankr. E.D.N.Y. 2011) ("a creditor's agreement to prepetition interest under Section 502, default or otherwise, is determined in the first instance by the agreement between the parties and applicable nonbankruptcy law"); Key Bank Nat'l Ass'n v. Milham (In re Milham), 141 F.3d 420, 423 (2d Cir.), cert denied 525 U.S. 872 (1998) ("[p]repetition interest is generally allowable [as a claim] to the extent and at the rate permitted under applicable noncontract law, including the law of contracts").

This article is limited to a discussion and analysis of major state and federal cases with respect to the ability of the lender to charge default interest and late charges in connection with a mortgage loan that remains unpaid at the maturity date of the loan, as well as the ability of a loan holder that is an assignee of the original loan holder to charge default interest and late charges if the original loan holder previously elected not to do so. Courts generally look closely at the adequacy and sufficiency of the language in the loan documents to determine whether default interest and late charges are due on the loan, especially in connection with loans that remain unpaid at maturity. This determination is crucial and clearly emphasizes the need for precise, accurate and comprehensive drafting of default and acceleration clauses in mortgage-loan documents, in order to avoid having to rely on a court to interpret ambiguous or incomplete language.

CASE LAW — COLLECTION OF DEFAULT INTEREST AND LATE CHARGES IN CONNECTION WITH LOAN UPAID AT MATURITY DATE

In In re Crystal Properties, Ltd., 268 F.3d 743 (9th Cir. 2001), the Ninth Circuit found that under the default language in the loan documents the lender could not collect default interest until it had actually accelerated the debt. The court held that the lender had never formally

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accelerated the loan by notice to the borrower, regardless of the fact that the applicable default provision stated that the borrower waived notice of demand or default. (The borrower filed a Chapter 11 bankruptcy case after the loan had not been paid at maturity.) The court further held that the maturity date of the loan did not constitute an automatic acceleration, and that under the language in the default clause, only an acceleration of the entire loan would trigger default interest. The court therefore upheld the bankruptcy court and district court opinions disallowing the bank's claim in its entirety.

See generally Joshua Stein, How Some "Standard" Language in a Promissory Note Cost a Lender Five Years of Default-Rate Interest Rate, Groundbreakers, 18 No. 4 PRAC. REAL EST. LAW. 60 (July 2002) (discussing and analyzing the Crystal Properties case, and providing excellent drafting tips to minimize the risk of improper or insufficient acceleration and notice); John C. Murray, Default Interest Rates, Late Charges, and Exit Fees: Are They Enforceable?, SM002 ALI-ABA 2679 (2006), at pp. 10-11 (discussing cases dealing with late charge imposed by lender after acceleration of debt.)

See also U.S v. Neudai, Inc., 14 F.3d 598 (4th Cir. 1993), 1993 WL 537722 (C.A.4 (S.C.)), at *3 (unpublished). The court's holding in this case is virtually identical to that of Crystal Properties, supra; i.e., the terms of the loan documents at issue dealt with acceleration of the debt, and there was no separate provision for charging default interest. The Fourth Circuit noted that "courts usually require that an acceleration be exercised in a manner so clear and unequivocal that it leaves no doubt that the borrower is apprised that the option has been exercised" (internal citation and quotations omitted). See also In re Zamani, 390 B.R. 680, 689 (Bankr. N.D. Cal. 2008) ("The record before me, as in Crystal Properties, fails to establish that ... the bank clearly and unequivocally notified [the borrower] that it was exercising its right to accelerate the notes").

Similarly, in JCC Development Corp. v. Levy, 146 Cal. Rptr. 3d 635 (Cal. App. 2 Dist., 2012), the court agreed with the holding in Crystal Properties, supra, and held that based on the language in the loan documents, the lender could not collect interest on the matured loan at the default interest rate because the default-rate provision was part of an acceleration clause that was not triggered before the note matured. According to the court:

The plain language of the note states that once one of the circumstances occurred which would accelerate the loan, "thereafter" interest could accrue at the maximum legal rate. The default interest language appears in the same paragraph as the acceleration clause, and there is no indication in the note that this language relates to circumstances other than acceleration (e.g., failure to pay the lump-sum payment at the time the loan matured). Levy, the drafter of the agreement, could have included language stating that the default interest rate applied not only after circumstances of acceleration, but also after the loan matured and no payment was made, but he did not include such additional language.

Id. at 643.

For general commentary on the JCC Development Corp. decision, see Prof. Dan Schechter, Where Debt Was Never Accelerated and Promissory Note Conditioned Default Interest on Acceleration, Default Interest Cannot Be Charged. [JCC Development Corp. vs. Levy (Cal. App. 2012].), 2012 COMM. FIN. NEWS. (2012). The author, noting that the court in JCC Development Corp. relied on the Ninth Circuit's holding in Crystal Properties, supra, stated that:

The [JCC Development Corp.] opinion lays out the simple drafting lesson: don't make default interest contingent upon formal acceleration. Make it automatic. Crystal Properties was decided more than 10 years ago; any deal booked after 2001 should have incorporated the lessons of Crystal; and yet we often see antiquated language in recently drafted documents. It might be a good idea for lenders' counsel to conduct periodic reviews of the form files, to make sure that the forms contain the "latest and greatest" provisions.

In United States v. Cardinal, 452 F.Supp. 542 (D. Vt. 1978), the court noted as follows:

The law is well settled that where the acceleration of the installment payments in cases of default is optional on the part of the holder, then the entire debt does not become due on the mere default of payment but affirmative action by the creditor must be taken to make it known to the debtor that he has exercised his option to accelerate, even though the note itself, as is the case here, waives notice of demand.

Id. at 547 (quoting Moresi v. Far West Services, Inc., 291 F.Supp 586, 588 (D. Hawaii 1968)).

See also In re Payless Cashways, Inc., 287 B.R. 482, 485 (Bankr. W.D. Mo. 2002), where the court stated that the same rule regarding acceleration of the debt applied in the Eighth Circuit as was applicable in the Ninth Circuit:

The court in Beal Bank v. Crystal Properties, Ltd., L.P. found that under both California law and the law of the Ninth Circuit, even if the terms of a note do not require notice or demand as a prerequisite to accelerating a note, the holder must take affirmative action to notify the debtor if it intends to accelerate. This is certainly true in the Eighth Circuit.

With respect to the court's holding in Payless Cashways, at least one commentator strongly disagrees with the court's decision, as well as the Ninth Circuit's decision in Crystal Properties, supra. See Prof. Dan Schechter, Oversecured Creditor Is Not Entitled to "Default Interest" Without Prior Notice to Debtor of Acceleration, 2003 COMM. FIN. NEWS.7 (January 20, 2003). The author states that, with respect to the bankruptcy court's holding in Payless Cashways:

The Ninth Circuit's decision in Crystal was wrong, and this one [the Payless Cashways decision] is "wronger." At least the Ninth Circuit tried to justify its result on the basis of California law, although California law does not clearly say that default interest cannot be triggered without notice when the contract provides for an automatic trigger. The Ninth Circuit's decision on this issue was also probably dicta, since the contract at issue in that case did not provide for default interest without notice of acceleration. Finally, the Ninth Circuit failed to distinguish between the triggering of the default rate and acceleration of the entire loan. Those two issues are not necessarily linked, although they often are linked in practice.

Here, however [in the Payless Cashways case], the court adopted the flawed rule in Crystal as if it were a Federal rule, which it is not. Also, the sweeping scope of the court's decision is unjustified, since the contract itself said that the default rate would only to the missed payment. The court had no

reason to promulgate a rule of general application to all credit agreements, to the effect that there can be no default rate applied to the entire balance in the absence of notice of acceleration.

Other courts have elected not to follow the Ninth Circuit's holding in Crystal Properties. See, e.g., Greystone Bank v. Skyline Woods Realty, LLC, 817 F. Supp. 2d 57, 62-63 (2011) (holding that when mortgage documents do not require notice of default and acceleration and provide that upon default lender may declare the entire debt due and owing, no notice is required and the "filing of a summons and complaint is sufficient notice of intent to accelerate"); In re South Side House, LLC, 451 B.R. 248, 266 (Bankr. E.D.N.Y. 2011) (bankruptcy court held default charge fully enforceable from date of default without notice to debtor, and stated that "As the Loan Documents provide that the default interest becomes due upon default, without notice to the Debtor, the default interest was due whether or not the Lender accelerated the Loan.")

In In re Deep River Warehouse, 2005 W.L. 1513123 (Bankr. M.D.N.C., June 22, 2005), the court allowed the full default acceleration rate to the lender, and distinguished Crystal Properties as follows:

The reasoning behind the court's refusal to allow interest at the default rate in Crystal Properties was not because the lender did not give notice of the default; it was because the lender did not perform the affirmative act of putting the debtor on notice that it intended to accelerate the debt. Id. at 749 (holding that courts have made clear the unquestionable principal [sic] that, even if the terms of the note do not require notice as a prerequisite to acceleration, the holder must take affirmative action to notify the debtor that it intends to accelerate). The Debtor's reliance on Crystal Properties is misplaced inasmuch as Crystal Properties did not hold that notice must be given before default interest can be charged against a debtor.

Id. at *4.

The court in Deep River Warehouse determined that the following factors should be examined to determine whether a specific default-interest provision should be enforced:

(1) the creditor faces a significant risk that the debt will be paid;

(2) the lower rate of interest payable pre-default is shown not to be the prevailing market rate;

(3) the difference between the default and the pre-default rates, and whether the differential between the two rates are reasonable; and

(4) whether the purpose of the higher interest rate is to compensate the creditor entitled to interest for losses sustained as a result of the fact that it was not paid at maturity or is simply a disguised attempt to penalize the debtor. Id. at *3-4.

The court in Deep River Warehouse specifically noted the importance of clarity in the applicable terms of the loan documents, stating that it must "read the terms of the Loan Documents in context, giving each term its plain meaning." Id. at *5. See also In re Harvest Oaks Associates, LLC, 2011 WL 124495, at *11 (Bankr. E.D.N.C. Jan. 14, 2011), which followed Crystal Properties in disallowing imposition of charges not claimed by prior holder. The court examined the facts of the case and the specific language set forth in both the promissory note and the deed of trust, stating that it "must first look to the language of the relevant loan documents." Id. at *6. The court held that "In this case, with respect to the payment default, there are insufficient grounds on which to deviate from the terms set out in the parties' agreement." Id. at *8. The court acknowledged that "whether interest will be allowed at the default rate is determined on a case-by-case basis and is fact specific," Id. at *7, and that it must "read the terms of the Loan Documents in context, giving each term its plain meeting." Id. at *3.

See also In re Croatan Surf Club, Inc., 2012 WL 1906386 (Bankr. E.D.N.C., May 25, 2012) In this case the court held that based on the factors considered by the bankruptcy court in Deep River Warehouse, supra, the default rate in question was within the range of reasonableness, "primarily because the difference between the default and pre-default rates is a mere 3% and therefore does not appear to be intended as a penalty." Id. at *4.

CASE LAW — COLLECTION OF DEFAULT INTEREST AND LATE CHARGE BY ASSIGNEE OF LOAN

Courts generally will not allow a loan holder that is an assignee of the original loan holder to charge default interest if the original loan holder previously elected not to do so. For example, in In re Sweet, 369 B.R. 644, 651 (Bankr. D. Colo. 2007), the note stated that "in the event of a default, the terms of the Note specifically provide the Note holder may in its discretion determine all amounts due and owing . . ." The assignee of the note argued that this language allowed it to retroactively apply the default rate of interest from the time the debtor ceased making payments on the note even though the assignee was not the holder of the note when the default occurred. The court rejected this argument, stating that "the original loan holder had never expressed any intent to charge default interest," and that the assignee of the note could not "retroactively substitute his discretion for that of [the original lender] in order to apply default interest to the [notice] when [the lender] first noted a default in the Note." Id. at 651.

See also In re Lichtin/Wade, LLC, 2012 WL 3260287 (Bankr. E.D. N.C., Aug. 8, 2012), at *5, where the court stated that "because the original loan holder . . . did not express an intent to charge default interest on the date of maturity, the assignee . . . cannot retroactively substitute its judgment for that of [the original loan holder]"; In re Crystal Properties, Ltd., LP, supra, 268 F.3d at 747 (finding it inequitable to allow present loan holder to recalculate interest for period when predecessor did not and considering the right to have been waived); Harvest Oaks Drive Assoc., LLC, supra, 2011 WL 124495 at *11 (Bankr. E.D.N.C. Jan. 14, 2011) (following Crystal Properties in disallowing retroactive imposition of charges not claimed by prior holder); In re 400 Walnut Associates, L.P., 461 B.R. 308, 314 (Bankr. E.D. Pa. 2011) (holding that waiver by mortgagee's predecessor of its contractual right to compound interest during time period when it held loan prevented assignee from retroactively compounding unpaid interest for that period of time).

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requirements and business rules. They also can automatically perform necessary calculations (the date of a specified period before the maturity date), flag areas of concern based on a combination of factors (an insurance requirement that is inappropriate in a particular shopping center), highlight provisions outside of expected results or rules, and warn against error (creating an error message in the document when a loan term does not match current loan program parameters).

Another advantage of a centralized document system is that changes to standard loan document forms can be instantaneously applied to every active transaction, if desired, and your standard forms are infallibly used for every transaction — no one mistakenly uses an out-of-date form or an improvised solution when a better standard answer is available.

Given the uncertainties associated with an ever-changing business environment and the practical realities of most negotiations, a good system also must permit "continuing automation" to address changes to transaction information after documents are first drafted, but before they are finalized. For example, since many terms are further negotiated after initial drafts are circulated, those fields in the documents must remain connected to the database through successive drafts of the documents, so the documents can be updated as additional information becomes available.

It is also important for the automation to be "portable" in the sense that it allows the user to create and send automated word processing documents or spreadsheets to third parties for mark-up or completion. Upon return, it should be possible to "re-attach" those documents to the automation database for further update and modification, rather than having to laboriously translate each comment received into an existing template.

Return on Investment

Building a strong document automation system for commercial real estate transactions requires an up-front investment of time by your most thoughtful professionals, as well as technological resources, but the return on investment can be tremendous. Transaction documents drafted using a well-designed automation system are not only more accurate, but less expensive and more timely than documents assembled by the cut-and-paste method.

As an added benefit, changes made to documents that are automated using a database-driven system can be easily reported for later analysis. Loan summaries can be prepared as automatically as the loan documents themselves — no need for staff to waste time culling through the paper file to create a summary.

Need to know how many loans had modifications to recourse provisions? How many times you permitted specialized transfer provisions across your portfolio or during a particular time period? Want to model the lease terms at a particular office building, or across several buildings in a single state? If your documents are automated, you can easily pull that information and provide it to managers or investors who need it.

Residential mortgage lenders and property managers have used document automation for years in various aspects of property acquisition/disposition, financing and leasing. The time has come for sophisticated document automation in commercial real estate transactions.

Katheryne L. Zelenock is a Member of the Real Estate practice of Dickinson Wright, PLLC. She represents commercial mortgage lenders and property owners on a national basis, making use of innovative transaction management and document automation software that she co-developed as a founder and President of e-Cognita Technologies, Inc., a software development company that created software for the commercial mortgage lending industry. Ms. Zelenock has been recognized as a leading real estate practitioner by Chambers USA, Best Lawyers in America, Michigan Super Lawyers and DBusiness (a Southeastern Michigan business publication).

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Leasehold Title Insurance: A Pathway to Closing

By: S. H. Spencer Compton, Vice President-Special Counsel, First American Title Insurance Company

Law school teaches that real property consists of a bundle of rights associated with certain estates or interests, foremost of which is the fee simple absolute.

Much has been written about the insurability of fee estates. This article will discuss title insurance products for leasehold estates and their practical value in consummating significant commercial lease transactions.

Just like fee owners and fee mortgagees, certain prospective tenants, tenants' assignees and leasehold lenders can benefit from the information furnished in a title report and the subsequent protections of a leasehold title insurance policy.

Nonetheless, only a few long-term lessors of high value real property with costly leasehold improvements purchase leasehold title insurance unless their lenders simultaneously purchase it, thus affording such lessors a discounted premium rate.

This is counterintuitive, given that the impairment or loss of a long-term leasehold estate due to a title claim or failure of title can be every bit as devastating to the tenant as such a loss or claim might be to a fee owner.

In addition, the leasehold endorsement to the 2006 ALTA owner's

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policy expands the policy as to the computation of loss or damage and identifies compensable items of loss for a policy insuring a leasehold.

The value question of whether or not to purchase a Leasehold Owner's title insurance policy is a secondary consideration. First, let us focus on what information can be derived from a leasehold title report:

1. Who is the fee owner of the premises (and thus the party with the authority to execute the lease as landlord)? Is there an overlandlord? Does this raise consent/recognition/estoppel issues?

2. What judgments and liens have been recorded against the fee estate? Does this raise creditworthiness concerns about the landlord?

3. If there is a mortgage(s) recorded against the fee estate, is it current or in foreclosure? If current, does this raise consent/non-disturbance/estoppel issues?

4. Are there any covenants or restrictions in deeds or easements of record that might limit the tenant's intended use of the premises? A covenant prohibiting the sale of alcoholic beverages could be disastrous to a tenant who intends to open a restaurant.

5. Are there any purchase options or reversionary rights? Changing landlords in the middle of the term of a lease can be problematic.

The answers to these questions can provide valuable negotiating leverage (or at least a reality check) to a prospective tenant or assignee.

A leasehold title report is inexpensive, can provide possibly critical due diligence, and, just as in a fee transaction, will establish a pathway to closing, identifying issues to be resolved prior to lease execution.

But what about paying the premium to turn that title report into a leasehold owner's policy? What does a Leasehold Owner's Policy insure?

Leasehold title insurance has evolved since the first ALTA forms were introduced in 1975, tracking the growing complexity of leasehold transactions.

In addition to insuring the possessory rights conferred by the lease, the Leasehold Endorsement to the 2006 Revised ALTA Owner's Policy addresses a host of collateral concerns:

1. Increase in market rent rates when rent is payable to a person having paramount title to the lessor under the lease;

2. If the tenant's leasehold improvements are not substantially completed at the time of eviction, the cost, less the salvage value, for the leasehold improvements up to the time of eviction (including costs of: land use, zoning, building and occupancy permits; architectural, engineering and construction management fees; environmental testing and reviews; landscaping; and fees, costs and interest on acquisition and construction loans);

3. Cost of relocating and repairing movable equipment and personalty to a new site within 100 miles;

4. The cost to secure a replacement leasehold equivalent to the lost leasehold;

5. Rent the tenant must continue to pay its landlord if the tenant is evicted from part of the leasehold estate;

6. The fair market value of the insured's interest as lessor in any

lease or sublease of all or part of the leasehold estate or the tenant's leasehold improvements;

7. Damages the tenant may be obliged to pay its subtenant; and

8. Defense of title claims adverse to the tenant's leasehold estate.

Coverages 1 through 7 above have no corresponding provisions in fee title insurance policies. These unique coverages have been expressly crafted to protect leasehold owners and lenders and address critical financial risks. Practitioners should discuss the value of these protections with their tenant clients before electing not to purchase a leasehold owner's policy.

How is the value of a leasehold estate determined? While the liability amount of a lender's leasehold policy is based on the amount of the mortgage (just as in insuring a mortgage on a fee estate), the various states use a formula similar to New York's to determine the amount of insurance to purchase for a leasehold owner's policy.

In New York, Section 7(A) of the Title Insurance Rate Manual of the Title Insurance Rate Service Association, Inc., approved by the New York State Department of Insurance (now a part of the State's Department of Financial Services), provides in pertinent part:

"(1) For leases having a term of six (6) years or less, an amount equal to the aggregate of the total rents payable under the lease; or

(2) For leases having a term of more than six (6) years, an amount not less than the aggregate of the total rentals for the six (6) years immediately following the closing of the lease transaction…; or

(3) Not less than the fair market value of the land and improvements at the time of closing of the leasehold transaction; or

(4) Not less than the appraised value of the land and improvements at the time of the closing of the leasehold transaction."

Note that, in (A)(1) above, whereas the six years or less term is regardless of whether part of the term has elapsed, it is unclear whether "total rents payable" includes only the base rents (thus excluding so-called additional rent comprised of real estate taxes, insurance premiums and other charges).

(A)(2) specifies that "on percentage leases, a statement of estimated rent may be used."

Section 7(A) also includes methodology for calculating the amounts of insurance applicable for (i) proposed construction ("the projected cost of improvements may, at the option of the insured, be added to the amount specified in (1 through 4, above)"; and (ii) an assignment of a leasehold estate ("the minimum amount of insurance is calculated by the greater of:

(a) The full consideration for the leasehold estate, including all mortgages assumed or taken subject to; or

(b) The value of the leasehold estate calculated by the method outlined in Section 7(A)(1) or Section 7(A)(2) above").

Certain other states, such as California, use the same formula to calculate the liability insurance amount, but use a different number of years in the lease term periods set forth in 1 and 2 above.

Recorded Interest

Absent a recorded interest, a lease will not be financeable and it may not be title insurable.

Typically, the landlord and the tenant may enter into a lease memorandum or, in some jurisdictions, a short form lease in recordable form, which sets forth certain of the lease provisions (the parties; the lease term; the description of the leased premises at a minimum).

It is unusual (but not unheard of) to record the entire lease. Where evidence of a leasehold interest is not already on record, even where the lease requires the landlord to enter into a lease memorandum or short form lease, it can be a long negotiation to get the landlord to cooperate.

The need for and status of a recorded leasehold interest should be addressed early on in any leasehold finance transaction or other leasehold transaction where title insurance may be required.

Landlord Estoppel Certificate

The certificate, executed by the landlord, should reference the lease together with all modifications, amendments, extensions and/or agreements pertaining thereto.

It should state that the lease "remains in full force and effect and that no event has occurred, or failed to occur, which, with notice or the passage of time, or both, shall become a default or Event of Default thereunder."

In the case of a leasehold mortgage and/or lease assignment, the certificate should set forth the landlord's consent to the mortgage and/or assignment, unless such consent is expressly not required by the terms of the lease.

Where a new lease is being executed at closing, the landlord's estoppel is usually not necessary (unless it is an overlandlord who must consent).

Approval Rights of the Fee Mortgagee

Where there is fee mortgage financing in place, any lease transactions will exist in the shadow of the mortgage loan documents. Leaseholds will likely be subordinate to the fee mortgage, unless and to the extent a subordination, non-disturbance and attornment agreement ("SNDA") is negotiated.

If the title report turns out a fee mortgage, the tenant's attorney may want to inquire whether the lender's consent is required for the lease transaction and, if the size of the lease transaction warrants it, whether an SNDA can be obtained.

Conclusion

When negotiating a significant commercial lease or ground lease, a saavy tenant's attorney, as part of his or her due diligence process, should consider mining the information contained in a leasehold title insurance report. Whether or not to turn that title report into a leasehold insurance policy by the payment of a premium can be decided as the transaction approaches closing.

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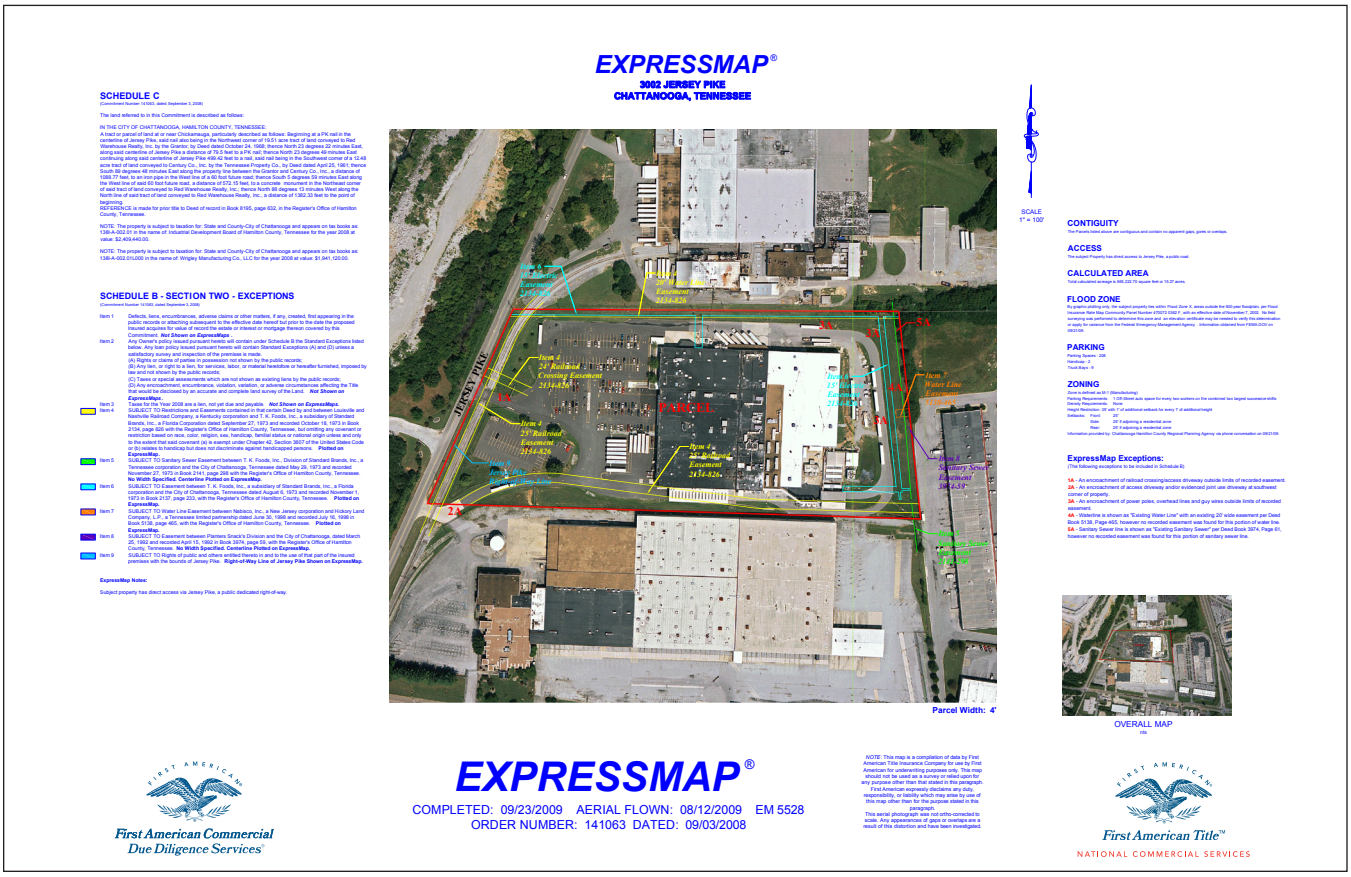

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