COMMERCIAL REAL ESTATE WORKOUTS AND FORECLOSURE ISSUES

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The news is mixed about the health of existing real estate loans in New Mexico. The Federal Reserve reported that as of the second quarter of 2011 both commercial real estate delinquencies and charge offs of commercial loans throughout the country are at their lowest in two years. (www.federalreserve.gov/releases/chargeoff/delallsa.htm) The *Albuquerque Journal* reported on November 18, 2011 that the number of foreclosures in New Mexico (both residential and commercial) increased between the second and third quarters of 2011, and New Mexico's delinquency rate of 6.4% is down from 7.4% a year ago.

In this challenging time, lenders and borrowers continue to restructure loans in order to keep them performing or to bring them back into compliance with agreed upon loan terms. This paper provides information about the loan workout process from both the lender's and borrower's perspective, including the pre-negotiation letter, due diligence to determine what workout strategy is appropriate, the terms of the forbearance agreement, and, finally, various workout options. We will also cover how workouts are affected by having multiple lenders and the roles bank regulation and regulators play in loan workouts. Finally, we'll address current issues in New Mexico foreclosures.

Loan workouts are necessary when a borrower can no longer service its debt to one or more lenders or otherwise defaults under its loan documents. Hence, the lender generally has the stronger bargaining position at the time of a workout and the process and documentation will reflect this power differential. Nonetheless, depending on the reason for default or potential default, a borrower and guarantor may still have some ability to direct the course of the workout arrangement, especially in the context of a non-recourse or limited recourse loan. The workout process generally begins with a pre-negotiation letter.

I. PRE-NEGOTIATION LETTER

When a project runs into trouble, it is in the best interest of the borrower and the lender to begin discussions on what should happen next. Lenders are motivated to talk to borrowers before a default occurs to try to address the problems and perhaps restructure the contractual arrangements to avoid a default on the loan while the borrower deals with the problems encountered by the project.

Once a default occurs, the lender will undoubtedly initiate a discussion with the borrower. The lender would much rather have the default cured than to have to initiate collection procedures. If something can be worked out, both the lender and the borrower are money ahead. Even where the lender and the borrower are unable to work something out, the lender benefits by having the discussions; if nothing else it can help demonstrate in a subsequent lender liability action that the lender acted reasonably under the circumstances.

Most lenders routinely now require pre-negotiation agreements. Until the most recent economic down turn, pre-negotiation letters were used primarily when the lender anticipated that the discussions about resolving a default or a problem with the loan would be prolonged or when the lender did not have faith in its borrower. The purpose of the pre-negotiation agreement is to avoid having a borrower misunderstand what, if any, promises the lender is making.

The simplest pre-negotiation agreement is a letter that merely acknowledges the parties are in discussion and until both parties have signed a written agreement, there is no agreement. A more formal pre-negotiation agreement would identify the parties and the nature of the default. It would recognize that the parties are agreeing to negotiate in good faith. It would contain a provision indicating that the loan documents have not been changed, that no defaults have been waived and that both parties are reserving all their rights. Other matters appropriately placed in a pre-negotiation agreement include a description of the defaults, a description of the proposed resolutions being discussed, a statement of the intention to maintain the status quo, the identity of the persons authorized to negotiate on behalf of the borrower and the lender and the ability of either party to terminate the discussions at any time. The pre-negotiation agreement could contain a provision that the communications and negotiations that will take place are being undertaken to achieve a compromise and settlement and are therefore confidential (in which case the lender needs to retain the right to disclose to loan servicers and participating lenders) and not subject to discovery if there is subsequent litigation. Lenders will require reimbursement of expenses and may charge a fee or a deposit on those expenses. Waiver of jury trial provisions are common. Finally, the lender may require that the borrower include a provision acknowledging lender's performance and releasing any claims against the lender.

The negotiations over the exact provisions of the pre-negotiation letter, especially with regard to releasing of claims, will come down to the relative bargaining positions of the parties. A borrower will need to consider whether they are aware of any claims against a lender before agreeing to waive them. It may be that a lender will allow the borrower to carveout known claims, but will want the borrower to waive any other claims it may have.

A form of pre-negotiation agreement may be found in Ann Ramsey's article *Real Estate Workouts from a Lender's Perspective, Appendix A* The Practical Real Estate Lawyer, Vol. 27, No. 4, July 2011.

II. DUE DILIGENCE

Due diligence in the context of a loan workout is usually thought of as actions a lender takes to determine the state of the loan documents, the obligors, and the collateral. However, borrowers and guarantors should undertake due diligence, as well, in preparation for workout discussions with the lender. A lender's due diligence includes reviewing loan documents, confirming lien position and title to collateral, and evaluating the project and obligors in light of the currently known facts.

A. Review of Loan Documents

At the time of a loan delinquency or upon borrower's notice of a situation where there will be a default in the near future (such as maturity of the loan without a take-out lender), the lender will undertake a review of the loan documents. This review will confirm that they are complete and don't contain any defects or mistakes and may provide other information about deal points and remedies that will be useful in a workout. Outside counsel to a lender may want to request copies of the loan documents to perform a review separate from the business review that may be done internally. In addition to checking for all signatures and all referenced exhibits (both on signed and recorded versions of documents), lender's counsel should check for any internal inconsistencies or ambiguities in the documents and confirm that all points from the loan approval checklist are covered in the loan documents.

Usually, loan documents contain provisions or a separate document that binds the borrower and guarantors to sign any documents necessary to correct mistakes. For example, a mortgage may contain the following language:

> The Borrower, upon the request of the Lender, shall complete, execute, acknowledge, deliver and record or file such further instruments and do such further acts as may be necessary to carry out more effectively the purposes of this Mortgage, to subject any property intended to be covered by this Mortgage to the liens and security interests it creates, to place third parties on notice of those liens and security interests, or to correct any defects which may be found in any Loan Document.

Even with this provision, in a workout situation a borrower or guarantor may attempt to use such mistakes as bargaining tools. Therefore, it is prudent for the lender to identify, evaluate and rectify such mistakes as early in the process as possible. Also, identification of a defect in the loan documents may change the lender's plan for a workout. For example, a lender may choose to forbear from enforcement while correcting a mistake in a legal description attached to a recorded document.

Document review will also provide a refresher on the business points of the transaction and may provide a path to workout that is specific to the particular property and lending arrangement. For example, there could be a limited or springing guarantor who might be a source of additional cash for an equity contribution.

B. Lien Position and Title Review

The lender and/or lender's counsel will want to confirm that the liens put in place at loan origination are still perfected and hold the same or better priority as at origination. Obtaining UCC searches, title searches, tax liens and litigation searches will provide a full picture of any other potential claimants for the borrower's assets.

Federal and state tax liens, for taxes other than ad valorem property taxes, must be searched in the county where the property is located, but such tax liens do not have to be indexed by the property description to be valid and enforceable against third parties. The Uniform Federal Lien Registration Act, which is also followed for state tax liens under Section 7-1-37 and 7-1-38 NMSA 1978, requires only that the lien be filed with the county recorder in the county where the property is located. Section 48-1-1 NMSA 1978. Therefore, tax liens must be searched separately from standard title records. Although they are indexed separately, state and federal tax liens encumber both real and personal property. As against a mortgagee, priority of federal or state tax liens dates from the filing of the notice of lien.

Municipal liens are also filed with the county recorder, and they require a legal description in their notice. Section 3-36-1 NMSA 1978. Municipal liens are liens imposed by municipal ordinance or under authority of law. *Id.* Municipal liens enjoy priority over all other liens, except "the lien of general state and county taxes." Section 3-36-2 NMSA 1978. However, liens in favor of a municipality are subject to a four year statute of limitations. *Hurley v. Village of Ruidoso,* 139 N.M. 306, 2006 NMCA 41; 131 P.3d 693; 2006 N.M. App. LEXIS 13 (Ct. App. 2006).

Certain types of municipal taxes have been given extra-special legislative treatment. The Lodger's Tax Act provides for a lien for occupancy tax imposed by a municipality or county on both the real and personal property of the vendor providing lodgings within the municipality or county. Section 3-38-18.1 NMSA 1978. The Lodger's Tax Act provides that no person can sell the property of such vendor without ascertaining the amount of occupancy tax due, and such a seller must pay the occupancy tax from the first dollars of the sale proceeds, before any other person with a claim on the sale proceeds. *Id.* This means that not only does the lien have a super-priority, the municipality or county does not need to actually enforce the lien to obtain payment. Instead, when there is a sale of the property, the sales proceeds must be used to pay any outstanding lodger's tax. The Court of Appeals has held that even if a municipality or county is named in a foreclosure action, it need not answer or in any way participate in that foreclosure action in order to be entitled to the sale proceeds under Section 3-38-18.1. *Wells Fargo Bank. N.A. v. City of Gallup*, 131 N.M. 293, 35 P.3d. 298, 2001 NMCA 106; 2011 N.M. App. Lexis 101 (Ct. App. 2011).

Mechanic's liens have a special priority treatment that can cause issues for a mortgagee. A statutory lien arises for any person performing labor, furnishing materials or surveying as described in Section 48-2-2 NMSA 1978 and has priority over any mortgage, lien or encumbrance that attaches after "the time when the building, improvement, or structure was commenced, work done or materials were commenced to be furnished…" Section 48-4-5 NMSA 1978. This statute has been interpreted by the New Mexico courts to mean that a lien by any subcontractor and material provider on a particular project has the priority date of the first work on the site or first delivery of materials to the site. *Valley Fed. Sav. & Loan Assn'n v. T-Bird Home Centers, Inc.*, 106 N.M. 223, 741 P.2d 826 (1987). Unlicensed contractors beware, however. Any contractor acting without a license has no right to file or claim a mechanic's lien. Section 60-13-30 NMSA 1978. Therefore, if a title search reveals a mechanic's lien that could have priority, it may be worthwhile to confirm that the lien claimant is licensed, as necessary, by the state.

Careful lenders and title insurers make certain that their mortgage is recorded prior to commencement of any work or delivery of materials; however, questions arise from time to time about when work was actually commenced or materials were actually delivered. Therefore, if due diligence reveals a filed mechanic's lien, additional investigation may be necessary to confirm the priority of the mortgage against the mechanic's lien and to make sure the lienholder doesn't dispute the priority. The time limits for recording a notice of a mechanic's lien under

Section 48-2-6 NMSA 1978, and limitations period for bringing an enforcement action under Section 48-2-10 NMSA 1978 may also provide additional areas of inquiry in the case of discovering a filed mechanic's lien on mortgaged property.

If the mortgage or loan documentation contains a grant of a security interest in personal property, a UCC search should also be completed. The proper office for filing a financing statement is the central filing in the state of the debtor's registration (usually the Secretary of State, but each state's UCC must be consulted). Sections 55-9-301 and 55-9-501 NMSA 1978. For example, if the borrower owning real estate in New Mexico is a Delaware LLC, the proper place for filing and searching the UCC records would be Delaware, not New Mexico. Of course, the county where the real estate is located is the appropriate place for a UCC fixture filing, and that filing would be shown on a real property search. Section 55-9-501 NMSA 1978. UCC filings must be continued every five years; therefore, the UCC record should be searched for a continuation statement if the original financing statement was filed more than five years earlier. Section 55-9-515 NMSA 1978. Continuation statements are not required for mortgages acting as fixture filings, but separate fixture filings, filed in the real property records, must also be continued. *Id.* If it's found that a continuation statement was not timely filed, a new financing statement must be filed; when a continuation statement is not properly filed, the financing statement lapses at the end of five years and ceases to be effective. *Id.*

C. Evaluation of Project Servicing the Debt

The lender will want to re-evaluate the project in light of current market conditions and vacancy rates (if it's a tenant-occupied property). It's customary to have a new appraisal performed, and as discussed below, is essentially required by bank regulators. Other questions a lender will want answers for are:

(i) What are the current and projected income and expenses for the project?

(ii) What is the current and projected cash flow?

(iii) Who is the operator and are there operational changes that could be made that would improve cash flow?

(iv) Is there deferred maintenance and are there existing reserves that can be used to complete the necessary maintenance and repairs?

(v) What are the current market conditions for this type of property?

(vi) Are there any environmental concerns with regard to the project?

Lenders with specific reporting requirements and inspection programs may have much of this information throughout the life of the loan. Likewise, lenders that required reserves may have the borrower's money available to meet some of the property needs. Nevertheless, at the time of a workout, a lender will want to, essentially, re-underwrite the loan.

Additionally, in reviewing the operation of the project, the lender may be confirming that none of the events set out in a carveout guaranty have been triggered. In non-recourse loans, it is common to have one or more guarantors enter into a carveout guaranty arrangement. These arrangements usually bind the guarantors to pay the lender damages associated with certain types of actions by the borrower. A typical list of events that trigger payment of damages under a carveout guaranty includes:

(i) fraud or material written misrepresentation;

(ii) waste of the property;

(iii) misappropriation of tenant security deposits, insurance proceeds or condemnation proceeds;

(iv) failure to pay ground rent, property taxes, assessments or other lienable impositions;

(v) failure to pay to the lender all rents, income and profits, net of reasonable and customary operating expenses, received in respect of a period when the loan is in default;

(vi) removal from the real property of fixtures or personal property, unless replaced in a commercially reasonable manner;

(vii) the out-of-pocket expenses of enforcing the loan documents following default, not including expenses incurred after the borrower has agreed in writing to transfer the real property to the lender by the lender's choice of either an uncontested foreclosure or delivery of a deed in lieu of foreclosure; and

(viii) terminating or amending a lease in violation of the loan documents.

In addition to the contractual obligation to pay damages associated with the carveout triggers, carveout guarantees also customarily contain a conditional guaranty of the entire indebtedness that is effective upon voluntary transfer or encumbrance of the property or upon the borrower filing bankruptcy.

D. Evaluation of Borrower and Guarantors

In addition to the underwriting of the property in its current condition and market, the lender will also re-evaluate the borrower and any guarantors. Even in a non-recourse loan, a lender will want to evaluate the integrity and business acumen of the borrower. It is ultimately the borrower's operation of the project that will generate cash flow to service the debt. Understanding the borrower's financial position may also reveal motivations with regard to other obligations. For example, if the borrower's principal is personally liable on another loan, that person may be working to repay that loan more diligently than a non-recourse loan. Likewise, a significant equity investment in the project may be a motivator for the borrower's principal to make a deal that allows the borrower the possibility of realizing a return on that investment in the future.

In looking at the borrower and guarantor, the lender may also evaluate whether there are other related people or entities that may be motivated to infuse additional capital into the project. In understanding the borrower's business structure in a context larger than just the one loan project, those other people and entities may become apparent.

E. Borrower's Due Diligence

A borrower should perform due diligence similar to that of the lender to prepare for workout discussions with the lender. The borrower will want to review the loan documents prior to approaching the lender with any notice of default or potential default. Likely, the borrower is aware of the financial covenants that have to be reported regularly, but the borrower needs to understand what will happen under the loan documents in the event of default. As things are beginning to turn toward the need for a workout, the borrower and guarantor should pay particular attention to the carveout guaranty triggers. For example, under the carveout provisions above, the borrower will want to be certain to send all rent and profits through to the lender and to be careful that all expenses are well-documented so that there is no question about reasonableness.

Checking for any other liens on the property and assets will be important, especially if there is a due on sale or encumbrance provision. A borrower will want to clear up any such liens prior to the lender checking the title of the property. In response to the bank's appraisal or even before the bank's appraisal, the borrower may want to have an independent appraisal performed. This third party information may give a borrower the ability to rebut a lender's determination of value.

The borrower should have an idea of what restructure the cash flow of the property will support. That will require good knowledge of the operations, income and expenses of the project. Who better to do that than the owner of the property? Additionally, to the extent possible, the borrower should also try to consider what restructure the lender is likely to be most comfortable with.

III. FORBEARANCE AGREEMENT

A forbearance agreement is one of several avenues for handling a workout. A forbearance agreement is sometimes called a standstill agreement and is an agreement where the lender agrees not to enforce its rights resulting from existing or anticipated defaults in consideration for new agreements by the borrower. The lender does not waive defaults during the forbearance period but retains the right to take action at the end of the forbearance period. During the forbearance period a borrower may be expected to cure the defaults, improve its performance; liquidate the collateral or refinance the loan, and a lender may take the opportunity to correct any problems with loan documentation or with perfection of liens.

In determining whether a forbearance agreement is appropriate, the lender will consider the entirety of the lender's relationship with the borrower. This would include the number and nature of the defaults. If a borrower violates a single covenant, it may be more appropriate to waive the covenant or amend the loan agreement than to enter into a forbearance agreement.

However if there have been numerous defaults or if the defaults are of a monetary nature or if there have been prior or repeated covenant defaults, the lender is less likely to simply amend the agreement and go forward and may be more inclined to require a forbearance agreement or other work out strategy. If there hasn't been a default but the loan is maturing and the lender has determined that an extension of the loan isn't appropriate and the lender doesn't believe that the borrower has the ability to repay or move the credit within the remaining term of the loan, the lender may propose a forbearance agreement even though the borrower has performed as agreed.

A lender is incentivized to do a forbearance agreement where the collateral can't be easily liquidated or where liquidating the collateral is likely to result in a loss to the lender or where the loan documentation is deficient. The current economic environment would suggest that most lenders will at least consider forbearance where the primary collateral is real estate. Many of the commercial loans that are maturing in 2011 and 2012 were made at the top of the market and were made at a time when many lenders were paying less attention to documentation than they are today. Also, of course, the market value on real estate has fallen over the last five years in every sector.

Forbearance agreements vary significantly depending on the nature of the credit, the nature of the borrower, and the kind of defaults, if any, that have occurred, and what the parties believe the end game will be. All forbearance agreements have certain elements in common. The recitals will identify the obligors, the loan documents, the existing collateral, the amount of the debt and the existing defaults. The substance of the document will define the forbearance period and if, and under what conditions, the forbearance agreement can be extended. It will define what the borrower is expected to do and what the lender will and will not do during the forbearance period. It will confirm the collateral position and fix any deficiencies and it will contain a waiver and release provision and probably an indemnification provision to protect the lender. It will define what constitutes a default under the forbearance agreement. The effect of a default would be to terminate the lender's forbearance and permit the lender to enforce it rights as a result of the original default and any default under the forbearance agreement and may provide for the appointment of a receiver. Finally a jury trial waiver would be included in any forbearance agreement. The agreement may require payment of a forbearance fee, adjustment of the interest rates and adjustment of the payment schedule during and after the forbearance period. It may provide for a discount to the borrower for repaying the loan during the forbearance period. It may also require refinancing or an infusion of equity. It may establish a cash management agreement and a lockbox and will likely require additional and more frequent financial reporting. At the end of the forbearance period, the forbearance agreement may provide that if the borrower performs, the lender will foreclose, waive the default(s) and or amend the credit agreement, or if the borrower has not performed during the forbearance period that the lender will accept a deed in lieu of foreclosure, agree to a short sale, or have a receiver appointed.

A form of forbearance agreement may be found in Ann Ramsey's article *Real Estate Workouts from a Lender's Perspective, Appendix B* The Practical Real Estate Lawyer, Vol. 27, No. 4, July 2011.

IV. WORKOUT OPTIONS

Depending on the nature of the problem, there are any number of alternatives for handling a problem that arises with a loan. For the minor problems, the answer may be as simple as the lender waiving the default or waiving the default and amending the loan agreement. A waiver alone would be appropriate for a single isolated default. A waiver and an amendment would be appropriate where the default may be ongoing but it is not a default which would cause the lender to question the borrower's ability to repay or the adequacy of the collateral. For more significant defaults, consideration of a forbearance agreement, a consent foreclosure, a deed in lieu of foreclosure, a short sale or some combination thereof are possibilities. The approach a lender will take depends on the nature of the default and the nature of the collateral as well as the relationship between the lender and the borrower. A lender will want a receiver appointed if the lender needs to take control of the collateral pending a foreclosure. This may occur where the lender is concerned that a borrower may be diverting the rents, where there is a need for funds to maintain or repair the collateral or to make tenant improvements which the borrower cannot afford. A lender is likely to want a receiver any time the collateral includes a building that is not owner occupied.

A deed in lieu is appropriate where both the borrower and the lender understand that a foreclosure is inevitable and where there are no junior liens. An agreement for a deed in lieu of foreclosure will recite the ownership and encumbrance of the property and that the value of the property is less than the outstanding debt. The substance of the agreement will, at a minimum, include the agreement to convey the encumbered property free and clear of all liens except the lender's mortgage, a mutual release, an agreement that the lender will accept the conveyance in full or partial satisfaction (in a stated amount) of the outstanding indebtedness, and acknowledgements that the borrower has independently determined the value of the collateral is less than the credit toward the debt that the lender is giving, and that the conveyance is not intended to be a mortgage deed. Because a deed in lieu of foreclosure does not strip any other liens off of the property, lenders must take care to search for any liens or other encumbrances that burden the property. Often, lenders take the property subject to the first lien mortgage. This practice provides the possibility of instituting a foreclosure action in the future if other junior liens appear.

A short sale is appropriate where there is a buyer on the horizon. Like the deed in lieu agreement the agreement for a short sale will recite the ownership and encumbrance of the property, and that the value of the property is less than the outstanding debt. The substance of the agreement will, at a minimum, include the agreement by the borrower to sell the property at a stated price, the agreement by the lender to release its lien against the property and to accept the proceeds of the sale, in full or partial satisfaction (in a stated amount) of the outstanding indebtedness, an acknowledgement that the borrower has independently determined the value of the collateral is less than the credit toward the debt that the lender is giving, and a mutual release

V. MULTIPLE LENDERS

A loan may have multiple lenders because of a variety of transaction structures: a subordinated loan, a mezzanine loan, a participated loan, or a securitized loan. The workout process can become more complicated because of the additional parties who need to be consulted and whose consent needs to be obtained. There will be additional documents that need to be reviewed to determine applicable provisions regarding what lender has authority to drive the workout process and which lenders have input in the workout process.

In a situation with separate debts to separate lenders, each lender will want to understand the payment and default status of the other loans. If a subordination agreement between lenders exists, usually the junior lender is only entitled to payment as long as the borrower is not in default under the senior loan documents. Conversely, a senior lender may need to give notice to junior lenders and an opportunity to cure the borrower's default. In considering how to approach multiple lenders, the borrower should take time to determine whether the subordinate or mezzanine lender has any realistic likelihood of recovery. If not, then the borrower may want to persuade the junior lender to waive its rights and allow negotiations to proceed with the senior lender. While that sounds potentially difficult, lenders are pragmatists, and, presumably, a lender with little to gain from a particular transaction may want to spend time on other projects. On the other hand, borrowers need to be mindful of the obligations between the lenders, as failure to follow those requirements can slow down the workout process. For example, if there is a cash management regime that is to be implemented by the senior lender upon a certain trigger, this process may be of particular importance to the junior lender. Failure of the senior lender to properly implement the process may cause undue strife between the two lenders, and the borrower can be caught in the middle.

In a syndicated or participated loan, if the participation agreement was entered into prior to 2008, it is likely that the agreement does not contain specific terms dealing with many of the issues that may arise in a workout situation; participation agreements were generally developed by the lead lender to sell interests in the loan and historically have not covered many of the issues presented in relation to a troubled loan. Under such a scenario, the lead lender has a fair amount of discretion with regard to the loan; however, most participation agreements require consent for enforcement or restructuring of the loan. There may also be provisions regarding one lender buying out a dissenting lender's position. However, such a buy-out may be at par, which may not be desirable with regard to a troubled loan. From a borrower's perspective, ambiguity in the participation agreement can slow down the workout process while the lead lender determines what steps it must go through and obtains necessary consents.

Securitized loans will have been bundled with other loans, and interests in the pool sold. Rather than dealing with one lender, there will be a servicer who represents all of the pool owners. Borrowers will find that the master servicer may be replaced with a special servicer upon a default. Therefore, the decision makers may change as the loan moves from troubled to delinquent. In fact, the special servicer may be the only party that has authority to modify the terms of the loan in a workout situation; therefore, the borrower may have to wait until an event that transfers the loan to the special servicer before being able to negotiate a workout.

VI. BANK REGULATION

In considering what a lender may be willing to do with regard to a workout, it is helpful to understand the regulatory context in which the lender operates. Here is an overview of the agencies that regulate different types of banks and lending institutions. The Dodd-Frank Wall Street Reform and Consumer Protection Act eliminated the Office of Thrift Supervision and provided that both national banks and federal thrifts (federal savings associations and federal savings banks) are regulated by the Office of the Comptroller of the Currency. The Federal Reserve regulates thrift holding companies and their subsidiaries, as well as state banks that are members of the Federal Reserve system. The Federal Deposit Insurance Corporation regulates state thrifts, and credit unions are regulated by the National Credit Union Administration. At the state level, the New Mexico Financial Institution Division also regulates state banks and thrifts.

Specifically with regard to workouts, in 2009 the federal regulators came together and developed a guidance document related to banks' operations with regard to workouts. The full guidance document, entitled "Policy Statement on Prudent Commercial Real Estate Loan Workouts" can be found at http://www.ots.treas.gov/_files/481163.pdf. Its provisions will appear prudent to both lenders and borrowers alike. It begins with the notion that a workout should improve the lender's likelihood of repayment of principal and interest. It provides in part that workout plans should be based on currently known financial conditions and the repayment capacity of the borrower. Further, collateral should be reflected at the current as-is value. Importantly, the policy statement provides that use of prudent loan workout measures will not subject an institution to criticism even if restructured loans have weaknesses. Prudent workout measures must include:

i. Updated, comprehensive financials on the borrower, the real estate and the guarantor;

ii. Current valuation of the collateral;

iii. Analysis of appropriate loan structure; and

iv. Appropriate legal documentation.

Borrowers should obtain available information about their lender's status with its regulators. Some information about regulatory action is confidential, but other information is available to the public. Formal enforcement actions, such as formal agreements and cease and desist orders must be published by the applicable federal agency. Borrowers may be able to find information about formal enforcement actions through the FDIC's website: www.fdic.gov/bank/individual/enforcement/. Informal enforcement actions, such as a memorandum of understanding, do not have to be reported. Therefore, a borrower has no way of knowing if regulators are preparing a formal enforcement action.

Knowing whether a lender is under an enforcement action can provide insight into the lender's motivation to modify a loan to keep or make the borrower in compliance. Given the workout guidance described above, a lender must be prudent, but if it is having regulatory difficulties because of its number of delinquent loans, its loan officers may be inclined to reach a modification agreement in order to pass regulatory muster.

VII. CURRENT ISSUES IN FORECLOSURES

Since the 2007 amendments to the Deed of Trust Act, we have seen more lenders using deeds of trust that incorporate the rights and remedies of the New Mexico Deed of Trust Act. Section 48-10-1 through 48-10-20 NMSA 1978. Nevertheless, in our experience, and that of our colleagues doing foreclosure work for lenders, lenders are still relying on judicial foreclosure rather than performing a trustee's sale, even if foreclosing a deed of trust. From our experience, the timeline for judicial foreclosure is not so long that a lender is willing to risk the uncertainty of being one of the first, if not the first, to proceed under the remedies provisions of the Deed of Trust Act. This section of our paper discusses the trustee sale process and addresses other current issues we have seen in foreclosures, including questions and foreclosure processes when MERS has been used as the mortgagee, the differences between using foreclosure searches and buying a foreclosure guaranty policy, considerations for a lien holder named in another's foreclosure action, and operational issues to consider prior to obtaining a special master's deed.

A. Enforcement Actions under the New Mexico Deed of Trust Act

The Deed of Trust Act provides a non-judicial process for foreclosure, but it is not necessarily faster than an uncontested judicial foreclosure. A trustee must first record a notice of sale, and the trustee's sale cannot occur earlier than ninety days after the notice is recorded. Section 48-10-10 NMSA 1978. The notice of sale must also be published and mailed by certified mail to any person who the real estate records reveal may have an interest in the property, as well as to all parties to the deed of trust, itself. Section 48-10-12 NMSA 1978. After all necessary notices have been timely given and the ninety days has passed, the trustee conducts the sale. The property must be sold as a whole for cash to the highest bidder. Section 48-10-13 NMSA 1978. The beneficiary can credit bid the amount of the debt. The Deed of Trust Act contemplates bidders carrying armloads of cash, as it requires that the sales price be paid immediately. Section 48-10-14 NMSA 1978. Upon payment, the trustee delivers the deed. *Id.* In contrast to an uncontested judicial foreclosure, the time period to sale is potentially a little longer, but the sales process is very similar to a special master's sale.

Upon receipt of the funds, the trustee distributes the proceeds, first, to the cost of sale, second, then to payment of contract secured by the deed of trust, then to payment of other obligations secured, then to junior encumbrancers in order of priority. Section 48-1-15 NMSA 1978. However, the trustee can discharge its duty with regard to remaining money after paying the beneficiary by depositing the remaining proceeds with the district court. *Id.* The trustee's job post-sale is potentially easier and faster than the special master's job, who must prepare a report, present it to the court, then deliver the special master's deed.

The trustor and the junior encumbrancers have a redemption right after the trustee sale, similar to that associated with a foreclosure sale. Section 48-10-16 NMSA 1978. The beneficiary also has a right to seek a deficiency judgment for a period up to six years after the sale. Section 48-10-17 NMSA 1978. However, the Deed of Trust Act prohibits any deficiency action on deeds of trust securing residential loans to low income households (those below 80% of the median income for the area adjusted for family size). *Id.*

B. MERS

MERS first became operational in 1997 and in 1998 adopted a two tier corporate structure: Merscorp, Inc. operates a national electronic registry system to track changes in servicing rights and beneficial ownership interest in mortgage loans that are registered on the MERS system and is the parent company of Mortgage Electronic Registration Systems, Inc. (MERS, Inc.), a bankruptcy remote corporation whose sole purpose is to act as mortgagee of record and nominee for the beneficial owner of the mortgage loan. The MERS Commercial System was launched in 2003 for the multifamily marketplace and was designed to eliminate the repurchase risk and cost associated with preparing, recording and tracking mortgage assignments. In almost any action involving a MERS Inc mortgage, an issue is raised about who is the proper plaintiff. New Mexico courts have recognized that MERS Inc. is an appropriate plaintiff in an action to foreclose a mortgage and while there are no reported cases addressing the issue, most district courts in New Mexico have also recognized that the established owner of the note and the servicer may bring an action to foreclose.

C. Foreclosure Search versus Foreclosure Guaranty Policy

It is the usual practice by foreclosure practitioners to order a title search prior to filing a foreclosure action, then to update that search after the *lis pendens* is filed, amending the complaint if any new lienholders are identified. While this is not a new issue, it is perhaps worth revisiting whether a foreclosing lender should rely on a foreclosure search or obtain a foreclosure guaranty policy. The advantage to simply obtaining the search is that it is cheaper than buying a title policy. The problem is, of course, that if the title company misses something, the search itself likely limits the company's liability to the amount paid for the search. Therefore, the title company has no obligation to correct the problem or contribute to the cost of correcting the problem. On the other hand, if a loan guaranty policy is issued, the title company will have to stand behind the foreclosure and will be responsible for correcting any problems resulting from an omitted lien holder. For example, if an omitted lien is discovered when the lender seeks to sell the property, the lender who only obtained a title search would be responsible for re-foreclosing or paying of such a lien. But, the lender with a foreclosure guaranty policy could look to the title company who issued the loan guaranty policy to insure over the omitted lien. The sale can go forward while the title company addresses the issue of the omitted liens.

Here is how foreclosure guaranty policies work. Prior to filing the foreclosure action, a lender purchases a policy that shows all matters to date. The policy is issued in the amount of unpaid principal indebtedness due under the lien or note secured by the security instrument to be foreclosed. A foreclosure guaranty policy costs 55% of the full basic premium. An owner's title policy will be issued to the successful bidder at the foreclosure sale upon issuance of the special master's deed. If a new owner's title policy is issued to a new purchaser within one year of the issuance of the foreclosure guaranty policy, 50% of the premium for the foreclosure guaranty policy is credited to the new owner's title policy. Issuance of the foreclosure guaranty policy triggers reissue rates as with any other title policy. Lenders will want to consider the cost and likelihood of omitted liens, but a foreclosure guaranty policy definitely provides more protection than merely obtaining a lien search. Depending on the amount of the debt outstanding, it may not be much more expensive than a foreclosure search.

D. Senior Lien Holder Named as a Foreclosure Defendant

Occasionally, the holder of the first lien finds itself named in a foreclosure action brought by a junior lien holder. The senior lien holder could choose to negotiate with the junior lien holder to leave the senior lien in place and assume the obligation secured by it. Or, more likely, the senior lien holder will want to counterclaim and cross-claim for foreclosure. In doing so, the senior lien holder needs to perform its own search, or purchase its own foreclosure guaranty policy, and confirm that the proper parties have been named. The senior lender will also need to make sure it properly serves all of the parties, even those already named. When reviewing title, make certain the notice of *lis pendens* is properly issued and recorded. The *lis pendens* will act to benefit the senior lien holder for its foreclosure, as well.

E. Licenses, Permits and Lease Arrangements

If a lender is going to be taking over an operating property upon foreclosure, the lender must confirm that all necessary licenses and permits to operate will transfer or have been re-issued to the lender prior to the effective date of the transfer of title. For example, the liquor license transfer process is lengthy, and even upon foreclosure of a liquor license, the purchaser at the foreclosure sale must complete the state transfer process prior to be allowed to operate the liquor license.

If the foreclosed property is a leasehold, the lender will want to confirm that the lease will allow the lender to step into the shoes of a tenant. Often, there are significant lease provisions that protect mortgagees, but it is also possible that the lease is simply silent with regard to assignment. However, if the lease prohibits assignment, there may be a question about the lender's rights to occupy the property under the lease.

If the foreclosed property is leased to a third party, then the lender will want to be certain that the lease does not contain any provision that would allow the tenant to claim either a breach of the lease or the right to vacate based on the change of ownership. Usually, a lender would have required an attornment agreement from tenants at the origination of the loan, which requires the tenant to attorn to the lender or another purchaser at a foreclosure sale.

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