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Distressed real estate and ADR

ANALYZING VARIOUS REMEDIES AVAILABLE THRU ADR WHEN A REAL-ESTATE DEFAULT ARISES

For obvious reasons, high interest rates have a negative impact on real estate. High interest rates increase borrowing costs, making it more difficult to buy, sell, and hold real estate. Property values fall when interest rates rise because the borrower's monthly loan payments are higher.

On the commercial real-estate side, office-property owners have been the most severely impacted by rising interest rates. Office properties have experienced higher vacancy rates because, since the COVID-19 pandemic, more employees are working from home instead of working from the office. While many companies are now requiring employees to come to the office at least a few days a week, office vacancy rates are still higher than they were pre-Covid. (See, *Offices Around America Hit a New Vacancy Record*, Wall Street Journal, Konrad Putzier (Jan. 8, 2024).)

Arbitration and mediation are often effective tools to work out troubled real-estate assets. While many parties may elect to resolve their dispute in court, the benefit of arbitration and mediation is, among other things, the ability to select an arbitrator and mediator with real estate experience to lead the parties to the right and, at times, creative and beneficial outcome.

Lender disputes

California permits non-judicial foreclosure. In a non-judicial foreclosure action, the borrower has 90 days to cure the default from when the notice of default is recorded. After the 90-day period elapses, the lender may record a notice of sale, which permits the sale of the property 21 days after the recording of the notice of sale. (Civ. Code, §§ 2923.3 to 2944.10.)

While non-judicial foreclosure is the most common lender approach to a default, a lender in California may instead pursue a judicial-foreclosure action. Sometimes a lender has no choice but to pursue a judicial-foreclosure action because of a defect in the loan instruments. In rare cases, for example, the loan documents may not contain a power of sale, requiring a judicial-foreclosure action.

A judicial-foreclosure action – unlike a non-judicial-foreclosure action – permits the lender to seek a deficiency i.e., the difference between the mortgage and the proceeds of the sale of the property. The borrower in a judicial foreclosure has the right to redemption up to one year after the sale of the property to a new owner. (Code Civ. Proc., § 729.030.)

Arbitration

Most loan documents do not contain an arbitration or mediation provision because a lender may obtain ownership of the property quickly through non-judicial foreclosure. In those cases where a lender elects to bring a judicial-foreclosure action, the parties may agree to arbitration. From a lender and borrower perspective, arbitration provides the parties more control in moving the case forward outside of the slow-moving court system.

Arbitration can also be more efficient than going to court. The parties can agree to expedited or limited discovery and opt out of the Code of Civil Procedure discovery rules. Often, in a judicial-foreclosure action, because the issues in dispute are limited, the parties may elect to opt out of taking depositions. Even so, a borrower may be less willing to agree to limited discovery because it may want to drag out the process with the goal of holding on to the property as long as possible, hoping that, with time, the economics of the property will improve.

Mediation

For both judicial and non-judicial foreclosure actions, the parties should pursue mediation. A mediator with the requisite real-estate experience can better guide the parties to a mutually beneficial solution. In every lender-borrower dispute, the lender and borrower have different goals. The lender's goal is to obtain the highest value for the distressed real-estate asset while the borrower's goal is to keep control over the asset as long as possible.

Mediation allows businesspeople to come together to craft a resolution. Pre-hearing mediation conferences are important to flesh out the parties' objectives to reach common ground. Mediation briefs are also extremely helpful to the mediator. The briefs help focus the mediator on the downside risk of the lender foreclosing on the property, whether it be lower property values or problem real estate that may prove difficult for the lender to dispose of following foreclosure.

Successful distressed real-estate mediations attempt to satisfy the goals of both the lender and borrower. The settlement often comes in the form of a loan modification, which will allow the borrower to remain in control of the property while also providing an incentive for the lender to compromise its claims.

Some ways to resolve a borrower default in a mediated agreement is to include (1) extending the terms of the loan, (2) requiring the borrower to make an up-front payment to reduce the debt, which also may provide assurances to the lender that the borrower intends to make debt payment going forward, or (3) reduce the loan payments for a period and make-up the reduced payments later. The goal of mediation is to empower the parties to strike a deal instead of blindly pursuing remedies that may not satisfy the goals of either party. To be enforceable, the agreement requires the execution of all parties. (Evid. Code, § 1123.)

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Resolving disputes with guarantors through ADR

Unlike a lender-default action, it is more common for actions against guarantors to be arbitrated. Some guaranty agreements contain an arbitration clause. Even when an arbitration provision is absent, the parties may agree to arbitration post-filing of the breach of guaranty complaint.

In arbitration involving a breach of a guaranty agreement, briefing is important. While the lender's breach of guaranty cause of action is a straightforward breach-of-contract claim, the defendant guarantor has more robust defenses. Among them, are asserting that the guaranty is a sham guaranty.

Civil Code section 2787 provides that a true guarantor is, "one who promises to answer for the debt, default, or miscarriage of another." A guarantor, therefore, cannot guarantee its own debt to circumvent the anti-deficiency laws. (*California Bank & Trust v. Lawlor* (2013) 222 Cal.App.4th 625, 638.) That is, the borrower and guarantor cannot be so aligned that they are deemed in the eyes of the law as the same. Expert-witness testimony is useful to flesh out whether the borrower and lender are distinct or the same entities.

Another critical point to consider in any guaranty action is whether the guaranty contains the Civil Code section 2856 waivers. To properly bring a guaranty action, the underlying guaranty must waive all rights and defenses that the guarantor may have because the debtor's debt is secured by real property. This means that the creditor may collect from the guarantor without first foreclosing on any real or personal property collateral pledged by the debtor.

Mediation is often the best way to resolve an action against a guarantor because it is efficient. An action on a guaranty is not entitled to any priority and resolution in court and even in arbitration may take a long time.

In mediating guaranty actions, mediation briefs, particularly from the guarantor, are essential to identify the legal defenses for the mediator and to highlight any potential financial issues that will make it more difficult for the lender to collect on any judgment or award. Like in the lender-borrower context, successful mediation will often give the guarantor more time to satisfy the debt while also providing enhanced or increased security to the lender. A settlement may include a payment plan or providing the lender with additional collateral. Because the real estate market is cyclical, solutions centered around providing the guarantor with more time are effective because circumstances may change to the positive, making it more feasible for the borrower or guarantor to satisfy the loan.

Attorney fee provisions are commonplace in guaranty agreements. This provides another incentive for the guarantor to participate in early mediation to avoid having to be responsible for what could be substantial attorneys' fees and costs incurred by the lender in pursuing the action. Code of Civil Procedure section 998 offers to compromise are often effective tools to cut off having to pay for the other side's fees and costs if they fail to obtain a higher sum at the hearing, but nothing provides certainty and savings like reaching an early settlement.

How the appointment of a receiver fits into ADR

Civil Procedure section 546, subdivision (a)(2) permits the appointment of a receiver where it appears that the property is in danger of being lost, removed, or materially injured, or when the condition of the deed of trust or mortgage has not been performed and the property may be insufficient to discharge the deed of trust or mortgage debt. The lender, in the commercial-property context, often seeks the appointment of a receiver after the foreclosure is commenced to maintain the status quo. The receiver is appointed as an officer of the court and is given powers to collect the rent and maintain the property to prevent the property from falling into disarray during the pendency of the foreclosure action.

The receiver is not a party to the foreclosure action but may play a key role in mediation by identifying issues with the property (environmental or otherwise) that the lender may want the borrower to address in settlement. When there are environmental issues involved, expert witness testimony on causation and costs to ameliorate the damages caused by the environmental issue is helpful.

The mediator must understand the scope of the environmental issues including the cost to remediate the environmental issues for the parties to reach an agreement. It is important to remember that when a receiver has been appointed, any settlement will need to make sure that the receiver is compensated for the work performed on behalf of the receivership estate.

ADR and multiple lenders

A further challenge in resolving a distressed real-estate matter is that there may be more than one lender involved. In such a circumstance, mediation instead of arbitration or a court proceeding is a better approach to resolving the dispute.

It is common for there to be more than one lender lending on the property. By law, the lender who records first is the most senior lender and recovers first in foreclosure. The lender who records later is deemed the junior lender and only recovers if there are monies left over after the senior lender's debt is satisfied.

Mediation is helpful to avoid the junior lender being wiped out when the senior lender forecloses on its debt. The junior lender may seek to "buy-out" the senior lender or otherwise pay down the amount owed by the borrower on the senior loan and increase its own loan to the borrower. To the extent the borrower continues to seek to control the party, having all the lenders present at the mediation is the only way to accomplish this goal.

Knowing the parties' goals is important for the mediator. Pre-

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mediation conferences help flesh out the parties' goals and objectives. Settlement is often reached by the borrower or junior lender(s) bringing in additional capital or additional security. Creativity on ways to bring in more capital and/or security from an outside investor or lender is where an experienced mediator adds the most value.

Mezzanine debt and ADR

A more complex situation arises when there is mezzanine debt on the property. A mezzanine loan is a loan to the owner or indirect owner of the property secured by a pledge of the equity interest of the property owner. Because the collateral of the loan is secured by the equity interest in the property, the Uniform Commercial Code applies in the event of default. Upon foreclosure, the mezzanine lender steps into the shoes of the borrower and then may be faced with a real-estate mortgage that is, or is at risk of being, in default.

Mediation is often the best tool when there is a cross-default of a mezzanine and mortgage debt. The mezzanine lender may need to bring in additional collateral or capital to provide additional security to the mortgage lender. Pre-hearing conferences are important to flesh out creative solutions that will keep the mezzanine lender or the original borrower in control over the property.

Mediation briefs that address potential business solutions are essential to bring about voluntary resolution. While the real estate remedies are straightforward, the potential business solutions that may involve new capital, investors or lenders are more complex and benefit from experienced mediators who successfully have crafted resolutions in similar circumstances.

Conclusion

Arbitration and mediation are effective tools to resolve disputes involving distressed real estate. Arbitration is particularly useful when dealing with judicial foreclosure actions and breach of guaranty actions.

When time is of the essence because of the expedited remedies being sought or when there are multiple parties involved with disparate interests, mediation is often the best approach to resolve a distressed real estate dispute. While a foreclosing lender and a distressed borrower or guarantor may have competing interests, mediation can lead to an effective business solution by crafting resolutions providing for new capital, investors, or financing to resolve the default. Much better results are possible when the parties work together to reach a resolution instead of simply pursuing the remedies provided by law.

Prior to joining Judicate West *as a neutral in 2022, Mr. Petlak spent over 20 years as a litigator handling a variety of disputes from intake to trial. He has expertise in real estate, personal injury, consumer finance, employment, and securities and has litigated many complicated business disputes. As a mediator, Mr. Petlak resolves disputes relying upon problem-solving techniques drawn from his many years of litigating and trying cases. apetlak@judicatewest.com.*