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Real Estate Workout Advisory

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Construction Lender Reminder: Lock In Your Rights to Use Your Borrower's Architectural Plans to Complete the Project!

Incomplete construction projects, common in the current downturn, raise a number of issues for property owners as well as their construction lenders. One issue receiving relatively little attention is what happens to an architect's claim for unpaid services in a borrower bankruptcy, and what rights the property owner, its construction lender, and even a potential buyer of the property through a bankruptcy sale will have to use the architectural plans to finish the project. These questions arise time and again, and the answer lies in the intersection between real estate finance, bankruptcy, and intellectual property laws.

Architects and owner/developers typically enter into form AIA or similar agreements (Agreement) that outline the scope of architectural services to be provided, and the fees to be paid for such services. The Agreement will often provide the developer with a limited license and right to use the architect's drawings, specifications, and related documents (Plans); however, the architect often retains ownership of the Plans and the intrinsic designs reflected in such Plans (Designs). It is also typical for a construction lender to require the architect to sign what is commonly referred to as a "will-serve" letter in which the architect acknowledges the mortgage lien on the property and agrees that the lender (or its successor, or a buyer of the property through foreclosure or a bankruptcy sale) can use the Plans and Designs to complete the project. Ideally, this will-serve letter will, among other things, (1) indicate that the lender's lien is at all times superior to any claim of the architect on the property, (2) cap the architectural fees that may accrue without the lender's prior consent, (3) prohibit any modifications or amendments to the Agreement without the lender's prior consent, and (4) indicate that the lender or any subsequent buyer of the property through a foreclosure, bankruptcy, or similar sale can use the Plans and Designs upon paying the architect the fees stipulated in the will-serve letter.

In the recent case of *In re Locust Street Managers, LLC*[1] filed in the United States Bankruptcy Court for the Southern District of New York, involving an unfinished apartment building in Westchester, New York, the borrower filed for Chapter 11 bankruptcy in response to the first mortgage lender's real estate foreclosure action, and ultimately worked with the lender to auction the property under Section 363 of the Bankruptcy Code. Similar to a foreclosure sale, this Code section generally allows property to be sold "free and clear"

of all liens, claims, and encumbrances, with such claims to apply to the proceeds of sale of the property in the same order of priority as such claims existed against the property itself.

The architect filed an objection to the Section 363 sale motion. In an attempt to recover what was claimed to be owed to him, the architect asserted that no party (including the successful bidder at auction for the property) could use the Plans or Designs without the architect's prior consent because to do so would result in violation of the architect's copyrights in the Plans and Designs. If successful, the architect would have prevented the property from being sold truly "free and clear," and the winning bidder might have chosen to not pursue its acquisition of the property (or at least the bidder would have adjusted its bid to take into account fees to be paid to the architect). Recognizing this conundrum, and questioning whether Bankruptcy Code Section 363 could in fact override the copyright protections to the Plans and Designs, Bankruptcy Judge Robert Gerber took a practical approach to the situation and entered an order that allowed for the "free and clear" sale of the property (including free and clear of the pre-petition fees owed to the architect) while preserving the architect's ownership rights in the Plans and Designs, but also giving the purchaser enough latitude to be able to hire its own professionals and finish the project without infringing upon the architect's intellectual property rights. The sale order[2] provided, in pertinent part, that:

> . . .the sale authorized hereunder shall be free and clear of all claims, liens and encumbrances, such liens, claims and encumbrances to attach instead to the Proceeds of the sale, subject to creditors' rights or priority under applicable law. The claims, liens and encumbrances to attach to the Proceeds, include, without limitation, claims asserted against any new purchaser of the Property (including the Purchaser) that arise by reason of the use and occupancy by the new owner or its agents, professionals and contractors of the Property including, without limitation, its photography or measurement of the Property.
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> Without limiting the foregoing, so long as the new owner or its architect or agents do not use the Plans, the new owner may use and occupy the Property, develop the Property, and complete existing projects that are the subject of the Plans, free and clear of existing and future claims of [the architect], including claims of copyright infringement.

Judge Gerber's decision also allowed him to avoid having to decide the hotly contentious issues of assignability of intellectual property rights under section 365(c)(1) of the Bankruptcy Code and successor liability issues. Judge Gerber found that the borrower's agreement with the architect was clear that (i) the architect owned the Plans and Designs and was merely licensing them to the borrower for use in the property, and (ii) the borrower could not assign the license to use such Plans and Designs other than to an affiliate. Given such language, the fact that the borrower was not selling the property to an affiliate, and the proposed purchaser was not proposing to assume and take assignment of the architectural contract, the Judge did not have to reach the issue under section 365(c)(1) of whether under "applicable non-bankruptcy law" the Plans and Designs could be assumed and assigned by the borrower to the proposed purchaser.

In sum, Judge Gerber's common sense approach to this potentially thorny issue should, if followed by other judges, provide real estate lenders with some degree of comfort that there may be ways to accomplish "free and clear" asset sales in the bankruptcy court freeing the property's buyer from having to pay for pre-petition architectural fees, notwithstanding an architect's attempt to assert its rights and stifle such sales. Moreover, Judge Gerber's form of order provides practitioners with helpful language that could prove useful should real estate lenders face similar issues in connection with the liquidation of distressed real estate.

Although Judge Gerber's decision in the *Locust Street* case enabled the property to be sold without the

encumbrance of the architect's claim, construction lenders would be well advised to consider adding express provisions in their will-serve letters to remove these litigation issues altogether by providing, among other terms, the following:

1. The construction lender's lien on the property is at all times senior to any claim of the architect on the property.

2. Upon a construction loan default and sale of the property ("Sale"), whether by foreclosure sale, deed in lieu of foreclosure, bankruptcy sale, or other sale, the architect's claim for unpaid fees will not be an obligation that encumbers any portion of the property and will not become a claim against the purchaser of the property ("Purchaser"), regardless of whether the Purchaser is the lender or its successors or assigns (whether by deed in lieu, credit bid, or otherwise), an affiliate of the borrower, or a third party.

3. Notwithstanding any assertion of copyright or other ownership interest of the architect in the Plans or Designs or in the electronic software files related to the same, the architect expressly agrees that such Plans, Designs, and software files may be used to complete the construction on the property upon a sale of the types referred to in paragraph 2 above, provided that the architect is paid an agreed-upon amount of fees. An election by the Purchaser to use such Plans, Designs, or software files under the previous sentence does not obligate the Purchaser to continue to use the services of the architect. In no event will the lender (or its successors or assigns) be liable to the architect for any claim related to the borrower or the property including without limitation for the fees owed by the borrower to the architect unless the lender (or its successor or assign) is the Purchaser, and then only to the extent provided in the will-serve letter.

So, the lesson learned is that a carefully worded will-serve letter is an important "ounce of prevention" at the outset of a construction loan that will prevent the need for a "pound of cure."

Should you have any questions relating to this case, or construction loans more generally, feel free to contact Morrison & Foerster's Distressed Real Estate Group.

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[1] *Locust Street* is a single-asset real estate case pending in the U.S. Bankruptcy Court for the Southern District of New York, Case No. 08-14621 (REG).

[2] Case No. 08-14621 (REG) (Bankr. S.D.N.Y., February 23, 2010, Docket No. 87).

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