Fall 2011

The Abstract

American College of Mortgage Attorneys

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President's Column

by M. Lawrence Hicks, Jr.

We look forward to seeing everyone at the 38th Annual Meeting of the American College of Mortgage Attorneys on October 13-15, at the end of which meeting the College will have the great fortune to have Darlene Marsh become President. Darlene will do an outstanding job. It seems like we were just in Quebec City, and now it is time to meet in San Diego at the fabulous Grand Del Mar. Ed and Karen Bullard have chosen a superb location. The golf course is supposed to be fantastic, and I believe several of our Fellows have already been practicing on that golf course. At this meeting, we will welcome many new Fellows as a result of the hard work of the nominating Fellows, the State Chairs and the Membership Committee.

This past Spring, we had an excellent Regents Meeting in Dallas that was well-attended by the Board of Regents, State Chairs and other Fellows. Keith Mullen gave us an excellent presentation on technology and our practice, and Keith and Alec Nedelman will follow this up with some brief social media remarks at the opening of the Annual Meeting. The highlights of this year have been the fantastic activities of various Committees which I describe in more detail below. As you perhaps noticed from the brochure on the Annual Meeting, the Program Committee, headed by Dena Cruz, John Hosack and Nancy Little, has put together another outstanding program. Both the Bankruptcy Committee and the Capital Markets Committee are up and running, and we will have presentations from some of the founding Fellows of both Committees at the Annual Meeting. The Corporate Counsel Committee, under the leadership of Alec Nedelman and Charles Higgins, has worked with the State and Provincial Chair Coordinators and the Program Committee to qualify for CLE credit for the first time for the program being presented at the Corporate Counsel Committee Meeting at the Annual Meeting with many of the states. This should be a great value to the Fellows who are with the Corporate Counsel Committee and increase their participation at future meetings. This is just one of the many items undertaken by the State and Provincial Chair Coordinators, Nancy Little and Bob Holmes.

The Opinions Committee, chaired by Lydia Stefanowicz and Doug Prince, has been working with the Technology Committee on a knowledge bank and was particularly active in developing a consultive resource, process and procedure on third-party opinions which it sent to all of us and which process is clearly working (*i.e.*, our Fellows are dialoguing). Finally, the Opinions Committee has been tasked with working with ACREL and the Real Property Section of ABA on a joint project for an annotated real estate opinion, which project will continue

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Editor's Notes

by Norman H. Roos

This Issue of *The Abstract* contains a number of interesting articles and reports, including Larry Hicks' farewell President's Report. Larry recalls a year of ACMA accomplishments and previews the coming Annual Meeting in San Diego.

In addition to Bev Levy's Executive Director's column, Rob Krapf's report on the Jurist Academy, and other features including ACMA Fellows in the News (and a special feature on new Lifetime Fellow Bob Johnson), this edition of *The Abstract* includes the following articles:

- *Ten Things That a Commercial Lender in Maine Should Know*—In his first *Abstract* article, Chris Devlin focuses on ten things that commercial lenders should know about Maine law—ranging from foreclosure methods to unique note features.
- *Enforceability of Carveouts to Nonrecourse Loans: Current Developments*—Long-time *Abstract* contributor, Jack Murray provides an insightful overview of case law surrounding the evolution and interpretation of non-recourse carveouts.
- *Mortgage Transfers and MERS in California and Elsewhere*—Prolific *Abstract* contributor, Roger Berhardt, traces a number of recent cases challenging mortgagees' rights to foreclose on property mortgaged in the name of MERS.
- *The Priorities of Proceeds and Rents*—In his companion piece (Roger is indeed prolific) for this issue of *The Abstract*, Roger Bernhardt addresses the priority of rent proceeds generated under a mortgage recorded before the filing of a tax lien but collected after the tax lien had been filed. After assessing case law on this issue, Roger discusses the need for a rent clause and offers a qualified endorsement of the Uniform Assignment of Rents Act.
- *The TOUSA Decision Revisited*—Do Bad Facts Still Make Bad Laws?—Dan Gentges provides a detailed discussion and analysis of the TOUSA decisions including the U.S. District Court's decision emphatically rejecting and overturning the Bankruptcy Court decision. Dan's article concludes with some guidance for lenders when considering fraudulent bankruptcy risks under the Bankruptcy Code.

Thanks to all of those who have contributed to this Issue of *The Abstract*. I would also invite those of you who have not submitted an article for publication in *The Abstract* to consider doing so.

I look forward to seeing you in October at the Annual Meeting in San Diego. ◆

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Executive Director's Column

by Beverly I. Levy, CAE

What an active year 2010–2011 has been!

The ACMA Committees have all been busy with conference calls, meetings, reports, recommendations, and excellent ideas. In fact, at this year's Annual Meeting in Del Mar, more committees will be meeting face-to-face than ever before. And, this year in particular, our committees are working together on many projects. Just one example of this committee collaboration is the Technology/Website/Webinar Committee, which is working very hard on the new and upcoming ACMA Website. The Technology Committee has been working closely with the Opinions Committee on its recommendation for a Knowledge Bank (as well as other excellent recommendations). The Technology Committee has also been working with the Business Development Committee on the inclusion of an on-line Referral Form to make it easier for Fellows to report Referrals. And, of course, all Committees have been consulted and asked for input.

Please remember that if you would like to serve on a Committee, please let me know. I will be happy to share that information with the President, who, of course, makes all of the committee (and all other ACMA) appointments.

The State and Provincial Chairs have also been very active this year. As usual, they are asked to perform quite a few duties for ACMA. They are asked to contact Fellows who have not paid their annual dues in order to find out why. This is always excellent feedback for ACMA so that ACMA can continue to provide Fellows the benefits that are most important. And, in this process, many non-paid Fellows have paid their dues as a result of the State and Provincial Chairs' reminder calls. The State and Provincial Chairs have been asked by the Mortgage Law Summary Committee to prepare and edit the individual chapters for the Summary. And, right now, the State Chairs are busy preparing the forms to submit to their respective states for pre-approval of the 2011 ACMA Annual Meeting CLE program. The State and Provincial Chairs (along with the two State and Provincial Chairs' Coordinators) do a wonderful job and deserve all the thanks we can give them.

There are not enough accolades for the ACMA Officers and Board of Regents who have done a yeoman's job in directing the American College of Mortgage Attorneys. Their dedication to the their responsibilities is unparalleled.

It is my privilege to work with all of the ACMA Fellows, in whatever role you each play. You are the most extraordinary individuals with whom I have ever worked. Thank you all for all you do. ◆

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Robert M. Johnson Elected Lifetime ACMA Fellow

Under the By-laws the Board of Regents may appoint and elect as a Lifetime Fellow a member or former member of the College who has made a significant contribution to the College. We only have a few Lifetime Fellows and this year the Regents appointed and elected Robert M. Johnson as a Lifetime Fellow. Bob served as President of the College in 1995 and played an instrumental role with Jim Rose in starting the *Mortgage Law Summary*. Those efforts significantly helped to elevate the profile of ACMA in the legal community.

Our colleague from Oklahoma, whose impact within ACMA and his community has truly distinguished this former ACMA President and multiple civic award recipient, has accomplished great things in his career. After completing law school in 1967, Bob was commissioned as a Captain in the U.S. Army. After completing his tour in 1970, Bob returned to Crowe & Dunlevy and has been with that firm throughout his career, serving as President and in other leadership roles in the firm.

One of Bob's greatest achievements was to chair the commission which organized, developed and funded the Oklahoma City Memorial dedicated to those who died in the bombing of the Murrah Federal Building. That task required six years of intense effort to complete and Bob continued to serve on the Board of the Trust which oversees the Memorial by appointment of the President of the United States. The Memorial has received world-wide recognition and acclaim for its design and impact. In recognition of his efforts, Bob was awarded an honorary doctorate at Oklahoma City University.

In 1996, Bob was the recipient of the Goodness of the Community Award from the Murrah Building Survivors Association. His other honors and recognitions include the Ellen Hardin Walworth Medal for Patriotism, the Outstanding Service to the Public Award from the Oklahoma County Bar Association, and the Distinguished Service Award from Oklahoma County and the Oklahoma City Historical Society.

Bob is pleased to have his children and grandchildren live near him and probably likes being the uncle of a Heisman Trophy holder and St. Louis Rams quarterback. According to our sources, fly-fishing has displaced golf as Bob's favorite hobby. Bob ties his own flies and claims to have used them effectively throughout North America, when he is not watching nephew Sam play football.

Some years ago the College created the Robert M. Johnson Award for Distinguished Public and Professional Service. The award was created to honor a Fellow who has exhibited unusually meritorious service to the public on behalf of the legal profession. The first honoree, and the Fellow for whom the award was named, was Bob Johnson. ◆

ACMA Fellows In the News

Alfred G. Adams

Recipients of the North Carolina Bar Association Citizen Lawyer Awards for 2011 were selected for recognition at the NCBA Annual Meeting, which was held June 23–26 at the Grove Park Inn in Asheville. One of the honorees is ACMA Fellow and Past President Alfred G. Adams. Congratulations Alfred!

Christopher J. Devlin

Christopher J. Devlin, a fellow from the State of Maine, is the co-author of the *Maine Commercial Lending Handbook*, available through Tower Publishing Company. The Handbook is the first book-length published guide to commercial lending in Maine.

Larry Hicks

ACMA President, Larry Hicks, was recently interviewed by BNA on the Slow Economic Recovery, the Commercial Real Estate Legal Industry and ACMA's Mission. The full article appears on page 6 of this issue.

Norma J. Williams

Commercial Real Estate Women (CREW)-LA has named its "Women at the Top 2011." One of the honorees is ACMA Fellow and Regent Norma J. Williams. Congratulations Norma!

The Jurist Academy

by Robert J. Krapf

As you will recall from the last issue of *The Abstract*, as the outgoing President, I awarded the College's presidential scholarship contribution in the form of a grant in support of The Jurist Academy of Widener University School of Law. Now in its fourth year, The Jurist Academy is designed to reduce impediments to legal education and professional opportunities for members of historically underrepresented groups. The Jurist Academy offers well qualified, aspiring minority legal professionals a two week, tuition free preview of law school admissions and academics as well as professions in the law. Its program includes LSAT preparation, intensive course work in the law and experiential learning through visits with eminent members of the Delaware and Pennsylvania Bench and Bar, all accompanied by personal mentoring.

The program helps support efforts to diversify our nation's bench and bar to reflect its population at large, by targeting tomorrow's leaders directly. This year, The Jurist Academy introduced 23 aspiring legal professionals to the skills needed to enter law school and the careers available to law school graduates. The students came from diverse colleges around the East, from Florida Memorial to Georgetown to West Chester.

I have attended the graduation ceremony for the Academy in the past and can report that its students are eager, bright young people who are thrilled and honored to be part of a program that gives them the tools they will need to pursue legal careers.

But the pictures tell a better story than I can write. ◆

ACMA Upcoming Meetings: SAVE THE DATES!

2011 Annual Meeting
October 13–15, 2011
The Grand Del Mar
5300 Grand Del Mar Court
San Diego, CA 92130

2012 Board of Regents Meeting
April 19–21, 2012
Royal Palms Resort
5200 East Camelback Road
Phoenix, AZ 85018

Room Rate: $275 per night, Single/Double Occupancy
Reservations: (800) 672-6011
Please mention the American College of Mortgage Attorneys to obtain the group rate.
Hotel Reservation Deadline: Friday, March 16, 2012

2012 Annual Meeting
October 11–13, 2012
The American Club
419 Highland Drive
Kohler, WI 53044

2013 Annual Meeting
September 26–28. 2013
Four Seasons Resort Jackson Hole
7680 Granite Loop Road
Teton Village, WY 83025

2014 Annual Meeting
September 18–20, 2014
Omni Mount Washington Resort
310 Mount Washington Hotel Road
Bretton Woods, NH 03575

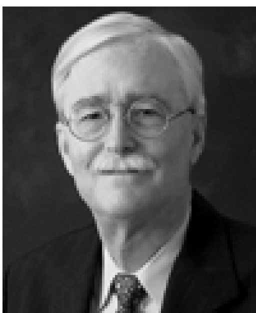
Industry Spotlight

INDUSTRY TRADE GROUPS

Recent economic trends have tilted upward, according to several key fundamental measures. But current indicators also point to a slow, drawn-out upswing. BNA's Eric Topor spoke recently with Larry Hicks Jr., the current president of the American College of Mortgage Attorneys (ACMA) and a real estate partner at Thompson & Knight LLP, about how the gradual recovery will affect commercial real estate (CRE) and real estate finance practices. Hicks said the broader economy and employment market will set the pace for any upturn in CRE prices, and predicted continued pain as owners of underwater properties continue to navigate the next five years. However, Hicks said he was confident that a rebound in CRE will occur, and advised CRE attorneys to expect increasing volumes of work from clients in the coming years.

Slow Economic Recovery Will Set the Near-Term Pace for Commercial Real Estate

BNA: What is ACMA's mission in the CRE legal industry, and how does ACMA serve its members and advance its goals?



M. Lawrence Hicks, Jr.

Hicks: ACMA is a national honorary organization of approximately 400 attorneys in 50 states, the District of Columbia and Canada, whose attorneys have substantial experience in real estate finance. Our fellows are mainly outside counsel, but we also have a substantial number of in-house counsel of institutional lenders and title companies. We also have a few academic and judicial fellows.

Our mission is to provide a group of fellows who are committed to the high quality practice of real estate finance law, and who come together in a collegial environment to support legislation, continue education, and similar matters relating to real estate finance law.

BNA: Does ACMA do any advocating on behalf of legislation, or government policy initiatives?

Hicks: We have a very strong committee system, and I am blessed to have inherited this very strong and effective and vibrant committee system. One is our legislation committee that is chaired by Jim Marsh and Eric Stauffer. They provide us updates on legislation, and sometimes we take positions on legislation. We are part of the synergy group which ACREL [American College of Real Estate Lawyers] is also a part of, it also includes the ABA [American Bar Association] Real Property Section, ICSC [International Council of Shopping Centers], and CREW [Commercial Real Estate Women]. And we have a joint ACREL-ACMA title insurance subcommittee. And yes, we do take positions on various things as they go through the process.

BNA: According to its website, one of ACMA's goals is to foster relationships between lenders and attorneys. How does ACMA facilitate those relationships?

Hicks: We partially do that by having in-house lender counsel as fellows at ACMA. We meet together in a collegial setting, at least annually, and because they are fellows with us, we try to solve joint problems that may be raised.

BNA: ACMA has an upcoming meeting this month, what issues do you expect to be raised?

Hicks: The meeting coming up is a Board of Regents meeting. We have 25 regents, it's an interim meeting, 60 fellows will attend probably, and we'll have reports from all the various committees. Very few of the in-house lawyers will be there, although Alec Nedelman, who is co-chairman of the corporate counsel committee will be there, and he is with a lender. Part of the agenda will be a brief educational program, and we'll talk about some problems in the recording area, the problems with MERS [Mortgage Electronic Registration Systems]. So we will have a presentation on MERS issues.

BNA: Aside from the MERS issues, which seem to be front and center in the residential foreclosure world, what other issues is ACMA confronting right now?

Hicks: We have a proposal from our opinions committee to provide an opinions database on our website. Part of our joint efforts with ACREL deals with legal opinions, so we have a continuing project there, ACREL is attempting to revise some of the opinions that they've already put out, and we're participating in that process.

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That helps everybody because having standard, form opinions helps keep legal costs down, which is relevant to the lenders and the borrowers. We are also considering updating our website for other matters to have links to state filings and state laws, and a knowledge bank.

Mortgage Law Practice Guide to Be Released. We are also considering putting our Mortgage Law Summary guide onto the website for fellows only. Our Mortgage Law Summary is published every two years, this year will be its eighth edition and it's in progress and will be published later this year. The Mortgage Law Summary is a summary of the mortgage laws of all 50 states and Canada. It's copyrighted, and available free to our fellows, but we also sell it on our website. We've been publishing it since the mid-'90s. It's one of the things that makes us unique, and one of the many things that our institutional clients in the lending industry find of great help. Laura McClellan will continue to edit it this year, and it is produced by the fellows in each of the states. It's a useful practice guide for lawyers and non-lawyers at lenders, in that it allows them to pick a state, and find out the security instrument used in that state—we have deed of trust states, mortgage state. It talks about the requirements for filing a lien, releasing a lien. Unfortunately, people look at it right now for how to do foreclosures in a state. It provides usury limitations, statutory references, it has a section on mechanic's liens, which unfortunately is relevant right now too, and title insurance. So it's become a very popular item. We sell probably 1,000 every two years of each addition.

My goals for ACMA are to continue to attract new fellows, and especially younger fellows, to keep ACMA relevant to its membership, and to continue to provide excellent education and other educational resources.

Upcoming Legislation and Regulations. BNA: The Republicans in the U.S. House of Representatives recently introduced legislation to accelerate the winding down of Fannie Mae and Freddie Mac, which included increasing fees for these two entities in order to make private lenders more competitive. What are your thoughts on that legislation, and will it have any effect on CRE if adopted?

Hicks: I have not studied [the legislation]. My superficial analysis is that it's restrictive; it's going to continue the gloomy times for the housing market. I'm not sure it's going to solve much in the short run. As you know, nationally, prices are falling for homes, [we've seen] six straight months of declining prices, January had a 3 percent lower price [level] than the previous January. Nothing's going to happen in my mind in home sales and home finance areas until the shaky labor market improves.

Tightening the credit, which I think is what these new proposals do, does not help that matter. But I'm not an expert at all in this matter.

BNA: The proposed risk-retention rules mandated by the Dodd-Frank legislation have just been released. What are your thoughts on risk retention in financial reform?

Hicks: I think risk retention is probably good. We've been waiting for these regulations to be proposed for some time. As you know, the CMBS [commercial mortgage-backed securities] market has returned. I attended the Mortgage Bankers [Association's] Commercial Real Estate Finance/Multi-Family convention in February. That organization is a lobbying organization, does take strong positions, and everybody was waiting for the Dodd-Frank rules to come out. At that time, they were hoping, with or without these rules, that the CMBS market would reach $25 to 50 billion this year. I think that [it will] probably get to the $25 billion easily enough, because the first quarter was about $9 billion—could be $12 billion by mid-year—and one would thing the $25 billion would be reached.

In my opinion, yes, we need some risk-retention rules, people need to have skin in the game, but I have not studied those rules yet.

Old deals need new cash, so there's just going to be a shortage of lending transactions no matter how much availability there is.

BNA: What volume of CMBS do you see the market settling at in the next few years, and what is a ''healthy'' level of CMBS activity in proportion of the overall lending market?

Hicks: I would imaging that it would settle in—not this year but in future years—at around $100 billion range, and that could be a healthy number. All this really depends a great deal on the economy. Right now people are optimistic, and the MBA [conference] everybody was optimistic compared to prior years. It sounded to me at that convention that life insurance companies had basically doubled their 2010 commitments. But there's just not enough product out there even for them at this doubled capacity. I think they're usually around 30 to 40 percent of the market; they might take up a higher percentage over the next couple of years as CMBS takes a little while to achieve its larger goals.

The problems are still there though, because of the falling property values. Old deals need new cash, so there's just going to be a shortage of lending transactions no matter how much availability there is.

BNA: It sounds like you're saying that there is enough cash available, but there is a continuing fundamentals problem with properties needing to be refinanced in the next five years that are now underwater. We've been hearing about that problem looming for a while now, is that still the case?

Maturities Promise a Bumpy Road Ahead. Hicks: I think that is a major problem, particularly with the properties that are currently securitized and that will be maturing in the next four or five years. The problem with values in my mind is the banks, and other institutional lenders—but particularly the banks—have not come to grips with their maturing loans, and with non-performing loans. And therefore, absent a great rise in property values, these maturing loans will not underwrite. Things would really radically change if the economy changed, which is not going to happen. Things will get better, the recover will be very slow, has been slow, and will be slow. As long as there is only a slow recovery, and as long as unemployment is high, then people will not be shopping as much, and they will not be filling the office buildings. So much depends on the economy.

BNA: You seem to be saying that property values continue to be down. Will that be true for transaction volumes as well?

Hicks: I think property values rising will be directly dependant on the economy. There is a possibility of course that there will be a significant increase. But my opinion is that it will be slow and steady. Transaction volume will increase in a slow and steady manner. There are many more transactions this year than last year, but they are a function of either maturing loans on very good properties, Class A, or heavy investment into Class A properties. It's still difficult to finance these [Class] B and C properties.

BNA: What will happen to these Class B and C properties when their loans mature in the next five years? Should we expect still more foreclosures, or keep extending and pretending for the foreseeable future?

Hicks: In the CMBS world I think there will be more foreclosures, and hopefully workouts. There will be commercial real estate changing hands, going back to the lenders, and eventually being sold, which will depress market values depending on where they are. The banks had been extending and pretending, and that may continue.

To me, the difference between this recession and the one 20 years ago is the fact that the banks are extending. Twenty years ago the government put pressure on the banks to move their low performing real estate, matured loans, defaulted loans, out of the banks, and to go ahead and foreclosure and take possession. In this recession, that has not occurred in the same volume as the past. I think that is really because nobody is putting the pressure on the banks to do that. That could change, and therefore there would be more foreclosures.

BNA: The federal debt and the budget deficit, and their implications for the broader economy have been hot topics in the media right now. Do you see either of those negatively affecting commercial real estate finance, or perhaps interest rates, in the near future?

Hicks: I don't think so, I believe interest rates will continue to be moderate throughout this year. I don't foresee any great swing in interest rates this year. However, I also believe that others may think the opposite, and that has led some amount of refinancing of very good properties while rates are still low. I think everybody has different opinions on that. Clearly the debt is an issue for the country, and for the recovery itself, but I don't think it's going to impact it this year, or the early parts of next year.

BNA: What are some things that a CRE finance lawyer should be doing right now to position themselves for the slowly improving market over the next few years?

Hicks: I think a commercial real estate lawyer should be staying in contact with his or her clients, because I believe many of them will be more active every year, for the next few years. The cycle has changed, and it's a slowly increasing up-cycle, and there will be more transactions and more work to do, from a positive nature. There's also going to be a continuing amount of work of a bankruptcy, foreclosure, and workout nature. So it would be relevant to stay in touch with your clients.

If we presume that the real estate finance attorney has extra time, he or she should learn more about Dodd-Frank than I know, and all of the problems in the industry in general. It's a time for continuing legal education. One of the things we do at ACMA at our annual meeting, which occurs in September or October every year, is provide seven to 10 hours of continuing legal education. This year we will have programs, for example a capital markets program chaired by two of [your publication's] editorial board members, Joe Forte, and Richard Goldberg. We'll continue to have a bankruptcy program, because I still think there are real estate bankruptcies in our future. It's a time for client relationships and continuing legal education.

In my mind, real estate finance attorneys have become busier in these last couple of years. Although I haven't seen any statistics, I have a feeling quite a few attorneys have left the practice area, as always happens in recession, retired early, become corporate lawyers, become oil and gas lawyers. And therefore, we probably have a little smaller bar right now. As you know, law firm hiring has been down the last few years, so we haven't brought as many people into the finance area or real estate practice area, either one. So I think my peers will be busy, this year and in future years.

There are many more transactions this year than last year, but they are a function of either maturing loans on very good properties, Class A, or heavy investment into Class A properties. It's still difficult to finance these [Class] B and C properties.

BNA: Do you see real estate attorney hiring picking up soon?

Hicks: I think it needs to pick up, I think you need to bring in young lawyers, and I think many firms are doing that this year, maybe even in the last year. There were reductions in force in real estate practice areas. [That practice area] probably had higher percentage perhaps than any other practice area in law firms. So hopefully law firms in general have been hiring young lawyers to put into the real estate area.

Past Recessions a Guide. **BNA:** How has the role of the CRE finance lawyer changed over the last couple years?

Hicks: If you look at it through my eyes, 35 to 40 years as a real estate attorney, I don't think there's been a change if you have this long horizon. I actually began as a corporate associate, and in the mid-'70s there was a small recession, and the corporate work generally went away. I moved to real estate because it was active and vibrant; part of that was because it was Dallas, Texas. But I've seen several other recession—late '80s early '90s being the most notable one, and this [current recession] is somewhat like that one.

Back 20 years ago, as I said early, there was a much greater percentage of foreclosures, and bankruptcies, and workouts than today. But the last few years, the real estate finance attorney has been doing modifications, extensions, foreclosures, bankruptcies, and the like. My prediction is that those will continue in the short run, for or five more years. There's still a good

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part of the $3 trillion of CMBS that will be maturing in the next five years, maybe it's only $2 trillion now because the other trillion has been worked out or foreclosed. But there are still these maturities in the future, and something has to be done with this maturing debt. In the CMBS world, that is generally going to be foreclosure, if it cannot be refinanced.

But going back to your question, this is, unfortunately, part of the cyclical nature of our economy. We all wish it would never happen.

BNA: Alternative fee arrangements have been continually touted as the new wave for legal billing for some years, even more so recently. Will alternative fee arrangements gain more prevalence in real estate finance?

Hicks: I believe AFAs, or alternative fee arrangements, have already taken off in the last few years. With the large institutions, I think there are quite a few out there. They're very prevalent with the large institutions, like banks. I don't think they're prevalent in lending, but in the default scenarios: bankruptcy, litigation, litigation relating to the housing industry, maybe even workouts and foreclosures. So I think you're seeing more in the last few years than you saw previously. I don't think we will see that much in the commercial real estate finance area, just because, in my opinion, most alternate fee arrangements make sense when there is a large volume, so you would need a large volume of lending from one lending organization and use one law firm to provide those services. Secondly, in many lending arrangements, the borrower pays the fees. So those fees, like surveyor fees, environmental consultant fees, other third party fees are just passed on from the lender to the buyer.

It is possible in the high volume areas, like home loans, you will find more AFAs. But in the commercial one off deals, I don't see it coming in the near future. But again, I think alternate fee arrangements in general, are a wave of the future.

In CRE finance—because it's generally a deal-by-deal basis—for 20 or 30 years, we've had some form of alternate fee arrangements, which we would call fixed fees, estimates with . . . capped fees. We've had to work within alternate fee arrangements generally in a manner different perhaps than some of the other practices.

**ACMA President, Larry Hicks was recently interviewed by BNA on the Slow Economic Recovery, the Commercial Real Estate Legal Industry and ACMA's Mission. Printed with permission from BNA.*

Ten Things That a Commercial Lender in Maine Should Know

by Christopher J. Devlin

Maine is a state of about 1,000,000 people and its small size and commensurately modest economy may explain why the State has not heavily regulated commercial lending. What does exist by way of pertinent law doesn't include any heart-stopping surprises, as the Maine case law and statutory concepts are, by and large, consistent with those of the rest of New England. Maine does have its quirks of commercial practice, though, and this article will attempt to highlight those as well as to provide some general information about the body of law that a commercial lender will face here.

1. Title Theory and Mortgage State. Maine uses mortgages, not deeds of trust, and subscribes to the title theory of mortgages, which means that the mortgage should include language of grant and defeasance in order to insure its enforceability. Mortgages may secure future advances subject to cut-off rights that may be exercised by notice from the mortgagor or a prospective junior mortgagee.[1]

2. Foreclosure Methods. Maine allows both for judicial foreclosure of mortgages (usually referred to as foreclosure by civil action) and a non-judicial method known as the statutory power of sale. Predictably, the power of sale method is the vastly quicker and simpler one. The power of sale is available only to entity grantors[2] and depends on inclusion in the mortgage of statutorily-prescribed language.[3] Acceptance of value (other than property revenue) on the mortgage debt during foreclosure may result in waiver of the right of foreclosure.[4] However, since "an agreement to the contrary in writing… signed by the person from whom the payment is accepted" will negate such an implication of waiver, most lenders include such language in the mortgage.[5]

3. Oral Loan Modifications and Agreements. Maine provides statute of frauds-type protection with respect to agreements to modify debt instruments and promises to make loans.[6] The statute applies only to indebtedness of more than $250,000.

The substance of the statute should be included in the commitment letter as well as in the other pertinent loan documents.

4. Anti-Deficiency Laws. Maine does not have California-type anti-deficiency laws, and mortgagor liability for deficiencies will ordinarily be limited only where the lender takes the property by bidding its debt at sale, in which case the deficiency is limited to the difference between the lender's debt (including expenses) and the fair market value of the property as established by appraisal.[7]

5. Usury. In Maine commercial transactions, there is no usury law applicable with the exception of 9-B M.R.S.A. § 432 (2009), which provides that the maximum legal rate of interest on a loan made by a financial institution, in the absence of an agreement in writing establishing a different rate, shall be 6% per year.[8]

6. Unique Note Features. Other than the statute of frauds language mentioned above, the lender may wish to include in its Maine promissory notes a recital that the instrument is signed under seal and is signed in the presence of an "attesting witness," in order to take advantage of a longer statute of limitations.[9] Some Maine lenders also add a merger clause to their notes to exclude oral evidence of contradictory

1 33 M.R.S.A. § 505 (Supp. 2009).

2 The statute limits the power of sale to mortgages granted by a corporation, a partnership, including a limited partnership, a limited liability company or the trustee of a trust. An additional limitation excludes mortgages given by trustees of trusts if, at the time the mortgage is given, the real estate is used exclusively for residential purposes, the real estate has four or fewer residential units and one of the units is the principal residence of the owner of at least one half of the beneficial interest in the trust. 33 M.R.S.A. § 501-A (Supp. 2009).

3 The statute describing the power of sale foreclosure procedure is found at 14 M.R.S.A. §§ 6203-A (Supp. 2009) & 6203-E (2003). 33 M.R.S.A § 501-A (Supp. 2009) gives the necessary ingredients for this remedy to be available.

4 *Casco Northern Bank, N.A. v. Edwards, et al., 640 A.2d 213 (Me 1994); citing 14 M.R.S.A. § 6204, repealed by P.L. 2007, Ch. 391, § 7 (effective June 21, 2007), now see 14 M.R.S.A. § 6321 (Supp. 2009).*

5 14 M.R.S.A. § 6321 (Supp. 2009).

6 10 M.R.S.A. § 1146 (2009).

7 14 M.R.S.A. § 6324 (2003).

8 *Id. at ¶ 10, 889 A.2d at 1018, Maine statutory law does not impose limits on interest on non-consumer loans. 9-A M.R.S.A. § 1-201(1) (2009). Maine decisions have not addressed whether an interest rate in a commercial loan could be invalidated on grounds of unconscionablility under the UCC.*

9 14 M.R.S.A. § 751 (2003).

payment terms that might be introduced under the widely-criticized decision of *Rogers v. Jackson*.[10]

7. Tidal and Submerged Lands. As a state whose economy depends greatly on the ocean, Maine has complicated laws on coastal land ownership. Maine law distinguishes between submerged land, which cannot be privately-owned, and intertidal land, which can have non-governmental ownership, but is subject to a limited public easement. Where improvements, such as docks, are located on submerged land, the owner must obtain a submerged land lease from the State of Maine and the lender will want to take an assignment of that lease and secure the State's agreement to recognize the lender as successor tenant.[11]

8. Elderly Guarantors. Maine's undue influence statute, 33 M.R.S.A. §§ 1021-1025, contains a presumption that any guaranty that is given by an elderly, dependent person to or for the benefit of a person with whom the elderly person has a confidential or fiduciary relationship is the result of undue influence, unless the elderly person is separately represented in the transaction by independent counsel.

10 In *Rogers v. Jackson, 2002 ME 140, 804 A.2d 379. Maine's highest court permitted introduction of parol evidence of an agreement that no payments would be required on a note unless the maker had sufficient funds, even though the note included express payment terms and due dates. The court reasoned that, even if the note were fully integrated, the oral condition was not inconsistent with the express payment terms of the note since "the condition, as a term of the larger agreement of which the promissory note is but one part, prevents [maker's] payment obligation under the note from coming into effect until such time as he can afford to pay."*

11 12 M.R.S.A. § 1862 (Supp. 2009). The Maine Bureau of Parks and Lands has a form for this purpose.

9. Environmental Liens. Maine affords a lien for all costs incurred by the State for the abatement, clean up or mitigation of hazards posed by any site designated an "uncontrolled hazardous substance site." The lien encumbers all real estate of the responsible party that has been included in the description of the affected real estate within a 3-year period preceding the date of filing the lien, not just the uncontrolled hazardous substance site.[12]

10. Uniform Laws. Maine has enacted Revised Article 9 of the UCC without material deviation. It has not adopted the Uniform Assignment of Rents law.

The above list hits several salient points and there is, of course, more. Helpful sources include the ACMA guide and the ABA's 50 state guide to commercial lending. In addition, the author recently co-wrote *The Maine Commercial Lending Handbook* (Tower Publishing 2011) which he hopes is a useful resource on the subject.

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12 38 M.R.S.A. § 1371(2) (Supp. 2009).

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Enforceability of Carveouts to Nonrecourse Loans: Current Developments

by John C. Murray

Introduction

Since the mid-1980s, lenders have been qualifying and restricting nonrecourse provisions in commercial real-estate loans by making exceptions for certain "bad acts" by borrowers. In recent years, many lenders have expanded the scope of such "carveouts" to include risks of exposure to the property's economic deterioration or neglect. Some nonrecourse provisions provide that the borrower is liable for the specific damages resulting from the violation or breach of a carveout, while others state that the entire loan becomes recourse to the borrower if any of (or certain of) the excepted acts occurs. In some cases the exceptions have virtually swallowed the rule; i.e., the clause is drafted so that the borrower has personal liability for virtually all defaults except the failure to pay the principal and interest due on the loan. There has been relatively little case law regarding the validity and enforceability of such carveouts, as these provisions have rarely been challenged by borrowers or guarantors. But in the current severely depressed commercial real estate market, with the commensurate increase in mortgage loan defaults, more federal and state court actions challenging the validity and enforceability of carveout provisions are being brought by borrowers and guarantors (mostly without success). This article will discuss and analyze recent developments and court decisions in this area.

Background and Evolution of Non-Recourse Carveouts

True nonrecourse loans are rare today. Commercial real estate values have substantially declined. In the past (and even currently, to a lesser extent) much real estate value was created by investors seeking tax or related benefits who were not particularly concerned about adding to—or in some cases even maintaining—the value of the property, or by foreign investors seeking unique opportunities or higher returns (however modest) than were available in their own countries. Many lenders began to realize—especially after being "burned" in bankruptcy proceedings filed by or against their borrowers—that standard nonrecourse mortgage provisions in some cases actually encouraged borrowers to contest lender enforcement actions and to file bankruptcy proceedings, as borrowers had no risk of personal liability and could delay or even avoid unfavorable tax consequences.

Lenders learned that, because of the absence of personal risk to borrowers and the lack of a direct monetary incentive for borrowers to properly operate and maintain the property, their security could suffer a substantial loss in the value that was originally determined as the basis for underwriting the loan.

The carevout exceptions to nonrecourse mortgage provisions have evolved from the traditional borrower "bad acts," such as fraud and material misrepresentation and the diversion of the loan proceeds, to include matters of conduct (or inaction or misconduct) related to the economic performance of the property, such as the misapplication of rental income, environmental contamination of the property, and physical or economic waste of the property (including non-payment of taxes). The exceptions to nonrecourse have expanded to include obligations to properly maintain the property and preserve its value.

Many of the cases deciding the enforceability of carveouts to non-recourse provisions are fact specific and depend on the court's perceived equity of the parties' positions. For example, in *Heller Financial, Inc. v. Lee* (not reported in F. Supp. 2d), 2002 WL 1888591 (N.D. Ill., August 16, 2002), the court rejected a challenge to the enforceability of a specific exception to the nonrecourse provision in the note executed by the borrower. One of the specific carveout covenants in the Note stated that each of the makers would "not [without the prior consent of the lender]… grant or permit the filing of any lien or encumbrance on the Project, the Collateral or the general partnership interest of the Corporation in the Partnership," other than those created by the senior loan documents and certain personal property leases. Subsequently six liens (in the form of tax liens and mechanic's liens) were placed against the mortgaged hotel property, none of which was consented to by the mortgagee or of which the mortgagee was notified. As the court in *Heller v. Lee* stated, "the

loan was secured by the equity interests of the entities that purchased the Hotel, and not by the Hotel property itself. This means Heller is concerned with the successful operation of the Hotel since it affects the value of the collateral that secured the loan. Any lien on the property compromises the equity interests of [the mortgagor's principals]. Thus, the carve-out under [the nonrecourse section of the Note] is of the utmost importance in acquiring the loan and is known and agreed to by all the parties." *Id.* at *4.

But the same rationale may arguably apply to other carveouts in nonrecourse mortgages: the prevention of deliberate "bad acts" by the borrower or the occurrence of acts or events that diminish the value of the property or divert or misapply the cash flow derived therefrom. With respect to the argument that carveouts from nonrecourse provisions are unenforceable liquidated damages provisions, the court in *Heller v. Lee* stated that, at least in Illinois, "courts lean toward a construction that excludes the idea of liquidated damages and permits the parties to recover only damages actually sustained (citations omitted)." *Id.* at *5.

Full Recourse Liability for Violation of Nonrecourse Carveouts

Many nonrecourse mortgage loans now contain covenants providing that the entire loan becomes recourse to the borrower if certain "blameworthy" defaults occur, i.e., those that are exclusively within the borrower's control. The borrower typically will strongly resist the imposition of conditions or covenants that would negate the nonrecourse provision and result in full personal liability, and will attempt to limit the lender's remedies to foreclosure and other rights solely related to the property (or, at most, quantifiable and limited damages). The following are examples of the types of "bad acts" of most concern to lenders, the breach of which many lenders believe should result in the imposition of full recourse liability against the borrower because they are within the sole control of the borrower: violation of the due-on-sale-or-encumbrance clause (including certain equity transfers); violation of the prepayment premium provision; the voluntary filing of a bankruptcy or reorganization proceeding; contesting the lender's foreclosure action or asserting a "lender liability" claim, affirmative defense, or counterclaim; environmental contamination of the property; and fraud and material misrepresentations regarding the borrower, the loan, the rental income from the property, or the condition of the property. The courts that have ruled on the validity and enforceability of carveouts to nonrecourse provisions generally have construed them in favor of lenders (even when violation of a carveout results in personal liability for the entire debt), rejecting borrower and guarantor claims of ambiguity, merger, lack of harm, or invalidity under specific provisions of the Bankruptcy Code.

For example, a recent decision by the Supreme Court of the State of New York, County of New York, *UBS Commercial Mortgage Trust 2007-FL1, Commercial Mortg. Pass-through Certificates, Series 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, No. 652412/10 (N.Y. Sup. Ct. Mar. 8, 2011), the court ruled that the Guaranty executed by the successor in interest to the subordinate mezzanine loan on the property in connection with a workout of the primary first mortgage loan ("First Loan") was fully enforceable as to the entire amount of the First Loan immediately upon the borrower's default. The Guaranty provided that the guarantor unconditionally guaranteed the payment and performance of the obligations under the Loan Agreement executed in connection with the First Loan the extent they arose after the acquisition of all or any part of the ownership interest in the First Loan borrowers by the Guarantor, and also provided that if the First Loan became fully recourse, the Guarantor would pay the guaranteed obligations immediately upon demand by the First Loan lender.

The court rejected the guarantor's argument that the Guaranty was in fact a "Bad Boy Guaranty" and thus an invalid and unenforceable penalty that sought to punish the guarantor without regard to the actual harm suffered by the First Loan lender. The court found that the guarantor was a sophisticated real estate investor and had waived the right to make such an argument pursuant to the explicit language in the Guaranty. The court also rejected the guarantor's argument that the Guaranty was against public policy, and ruled further that the Guaranty was "for the payment of money only," as required by New York law in connection with a motion for summary judgment in lieu of a complaint.

In another recent decision, *J.E. Robert Co. v. Signature Properties, LLC*, 2010 WL 796774 (Conn. Super., Feb. 3, 2010), the court held that the mortgagor breached the terms of an $8.8 million mortgage on a commercial property by transferring a portion of the mortgaged collateral without the lender's consent when it terminated a parking license agreement ("Parking Agreement"). The court reasoned that the Parking Agreement, which was entered into between the mortgagor and an affiliated entity, was a loan document

that was required as part of the original mortgage loan transaction and was therefore subject to a specific carveout provision in the (otherwise nonrecourse) mortgage prohibiting (among other things) an unpermitted transfer of any part of the property without the lender's consent; thereby resulting in the entire mortgage debt becoming a full recourse obligation of both the mortgagor and the guarantors (jointly and severally, including any deficiency judgment). (The Guaranty provided that if the recourse provisions of the Note and Mortgage were triggered, "then the Guaranteed Obligations shall also include the unpaid balance of the Debt"). The mortgagor ceased payment on the mortgage loan approximately two years after the termination of the Parking Agreement (apparently because there was a major vacancy at the mortgaged property).

The court noted that the term "Property Mortgaged," as defined in the mortgage, was "broadly defined… to include not only the real property… and the improvements, but also all agreements, contracts, licenses, and other documents, and all rights therein and thereto, respecting or pertaining to the use, occupation, management or operation of [the mortgaged property]. *Id.* at *6. The court gave a broad definition to the term "Transfer," which the mortgage defined as "any voluntary or involuntary sale, conveyance, mortgage, grant, bargain, encumbrance, pledge, assignment or transfer of all or any part of the Property or any interest therein …" The court also ruled that the fact that the Parking Agreement created a license only was immaterial, as it did not negate the fact that "the agreement created enforceable contractual rights." *Id.* at *7. The court reasoned that the Parking Agreement had a specified term and stated that: "While in Connecticut, a license to enter property is, in general, revocable at any time, the Parking Agreement does not so provide." *Id.* at 9.

The mortgagee also argued that the mortgagor had violated a specific clause in the carveout provision of the mortgage that prohibited a transfer of any assets to an affiliate or "other person or entity" without the mortgagee's consent. The court agreed with the mortgagee, stating that "An enforceable contract right is an asset." *Id.* at *10. The specific carveout clause provided that the mortgagor may not "commingle its assets with the assets of any of its partner(s), members, shareholders, affiliates, or of any other person or entity or transfer any assets to any such person or entity…" *Id.* The court also ruled that termination of the Parking Agreement was not an immaterial breach because the additional off-site parking would help attract tenants and by eliminating the availability of the additional parking spaces, a transfer had occurred because no prospective tenant of the mortgaged property could utilize them. The court further rejected the "misrepresentation defenses" of the mortgagor (i.e., equitable estoppel; unclean hands; breach of implied duty of good faith and fair dealing; and laches) because there was no evidence presented to support these claims. Finally, the court ruled that the mortgagee owed no duty to mitigate and the fact that the Parking Agreement "runs with the land" was immaterial.

The court's decision in the *J.E. Robert Co.* case indicates the term "transfer" may be broadly construed by a court in connection with a carveout provision in an otherwise non-recourse loan, even if only a partial transfer occurs. Also, the level of materiality may not affect the amount of damages awarded by the court if the language of the carveout provision specifically applies to partial transfers. Any ancillary agreements or documents executed in connection with the mortgage loan (e.g., leases, license agreements, reciprocal and other easement agreements, conditions, covenants and restrictions, management agreements, and conveyances of outparcels) should be drafted carefully and reviewed for possible existing or future violation of carevout provisions in non-recourse mortgages (including the term of such agreements and the ability of the mortgagor or its property manager to renew, replace, or terminate such agreements). The mortgagor and mortgagee also may wish to negotiate as to whether only an entire transfer of the property—or perhaps a transfer of all or a "material" or "substantial" portion of the property—would trigger full nonrecourse liability for the mortgage debt (with some attempt to define or limit "material" and "substantial").

In *Blue Hills Office Park, LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 366 (D. Mass. 2007) (which may be the first reported decision in which a court has enforced recourse of "bad boy" carveouts in a nonrecourse securitized loan), the court held that when the borrower settled a zoning appeal—in this case for $2 million—and failed to disclose the settlement to the lender or seek its consent (as required by the mortgage loan documents) and diverted the funds to itself, the borrower (and the guarantors) would be liable for the full amount of the loan ($17.5 million), and not simply the restitution amount of $2 million. (The high bidder at the lender's foreclosure sale, instituted after the borrower defaulted on its loan payments, was a single-purpose entity created by the lender, which later sold the property to a third party.)

The court ruled that the settlement was part of the "mortgaged property,"

which, as described in the loan documents, included "Awards or payments… with respect to the Premises… for any… injury to or decrease in value of the Premises." The nonrecourse provision in the mortgage (which obviously was carefully negotiated) specifically provided that if the borrower diverted funds from the mortgaged property that belonged to the lender, the borrower's and guarantors' liability would become recourse for the entire loan balance (certain other borrower acts and defaults, such as fraud, intentional physical waste, or removal and disposal of mortgaged property after default, would result only in limited liability of the mortgagor and guarantors for actual damages).

The court also found a second violation of the nonrecourse carveouts—the borrower had violated single-member and single-purpose-entity requirements in the loan documents by commingling the $2 million settlement payment with monies of its member and by failing to maintain a participating independent director. Although the borrower had named as the "independent director" an individual who once worked as a paralegal or secretary at the borrower's law firm, the court stated that "it is clear that she did not participate in the management of Blue Hills in that capacity," *Id.* at 383, and that she "was not involved in the discussions concerning the $2,000,000 settlement payment." *Id.* Therefore, the court held, the borrower had violated a specific mortgage covenant because it had failed to "cause there to be" an independent director and had failed to maintain its status as a single-purpose entity.

In another case, *CSFB 2001–CP–4 Princeton Park v. SB Rental 1, LLC*, 410 N.J. Super. 114 (2009), the mortgage note contained a non-recourse provision, which precluded the lender from seeking recovery against either the borrowing entity or its principals (as guarantors) if a loan default occurred. But the note also contained a carve-out clause stating that the debt would be fully recourse if certain acts occurred, including failure to obtain the lender's prior written consent to any subordinate financing encumbering the property. (The guaranty executed in connection with the loan held the principals-guarantors liable to the same extent as the borrower). The court found that the borrower subsequently violated this specific carveout by obtaining subordinate financing in the amount of $400,000 and permitting a second mortgage on the property to a third-party lender without first obtaining the first mortgagee's consent. The court rejected the borrower's argument that since the breach that triggered personal liability was eventually cured, resulting in no harm to first mortgagee, enforcement of the carveout here was unfair and unjust.

See also GCCFC 2006-GG7 Westheimer Mall, LLC v. Okun, 2008 WL 3891257 (S.D.N.Y., Aug. 21, 2008) (holding that guarantor under non-recourse loan was liable, under non-recourse carveout provision in loan documents, for full amount of loan under specific terms of loan guaranty when borrower filed a voluntary bankruptcy petition); *111 Debt Acquisitions LLC v. Six Venture, Ltd.,* 2009 WL 1255102 (S.D. Ohio, May 4, 2009) (ruling that provision in guaranty, combined with language in loan agreement, providing for full recourse liability for violation of specific carveouts, was enforceable against guarantors if borrower filed for bankruptcy).

Limited Liability for Violation of Nonrecourse Carveouts?

On the other hand, certain carveouts relating to the lender's efforts to protect itself from a loss of the property's value, or the diversion, misappropriation, or misapplication of the property's income stream, may be more amenable to a limited quantifiable-damages remedy. The following are examples of these types of covenants: the failure to properly apply insurance or condemnation proceeds to the restoration or repair of the property and the improvements thereon; the diversion or misapplication of security deposits and unpaid rents; the misapplication or diversion of rental income after a loan default; the failure of the borrower to perform its obligations as landlord under leases in effect on the property; physical neglect or waste of the property; "economic waste" of the property (such as the failure to pay property taxes and assessments); failure to discharge mechanic's liens and other monetary encumbrances and judgment liens against the property; failure to insure the property or pay the insurance premiums when due; failure to comply with applicable laws and regulations affecting the property; failure to maintain the property in a "suitable condition" to prevent loss of value; and removing or "stripping" personal property essential to the use and operation of the property and the buildings and improvements thereon.

Some courts may look to the length and severity of the breach, and seek to impose an "equitable" remedy where full recourse is sought by the lender for breach of a nonrecourse carveout. *See, e.g., ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition LLC,* 2010 WL 653972 (N.Y. Sup. Feb 24, 2010). In this case, the court refused to enforce a non-recourse carveout provision in the loan documents that would have made the guarantors fully liable for the debt. The plaintiff, ING Real Estate Finance (USA) LLC ("ING"), argued that the defendant borrower

and guarantors violated the terms of a "Full Recourse Event" clause contained in the Credit Agreement executed by the borrower, because of the failure to pay real estate taxes due in the amount of $278,759.20, which resulted in a tax lien against the property.

The court in *ING* found that one of the provisions in the Credit Agreement, which explicitly provided for a thirty-day grace period upon the filing of a lien before recourse could arise (the delinquent taxes were paid in full six days after ING amended its complaint to include the guarantors, well before the expiration of the one-year period during which the city of New York could institute a foreclosure action for unpaid taxes), was the controlling provision in this case. ING argued that another provision in the Credit Agreement, the "Full Recourse" provision, provided for full and immediate recourse liability of the guarantors if the borrowers incurred any "Indebtedness" (as defined in the Credit Agreement to include "obligations secured by any Liens, whether or not the obligations have been assumed"). ING asserted that the borrower's failure to timely pay the real-estate taxes was a Full Recourse Event under the Credit Agreement, and that the Guaranty Agreement executed by the guarantors concurrently with the Credit Agreement provided that the guarantors' full liability would be triggered in the event of the occurrence of such a Full Recourse Event. The court reasoned that where a document contains conflicting or contradictory language, "specific provisions control over general provisions." *Id.* at *4 (internal quotations and citation omitted). The court deemed the provision providing the cure period to be the more specific provision because otherwise other provisions of the Credit Agreement would be read out of the Credit Agreement or rendered meaningless (such as the provision entitling the borrower to contest any tax lien). The court also noted that under New York law, the terms of a guaranty are to be strictly construed in favor of the guarantor(s). The court in effect applied a liquidated-damages analysis to this issue, stating as follows:

> Immediate liability for the entire debt is not a reasonable measure of any probable loss associated with the delinquent payment of a relatively small amount of taxes. Here, pursuant to Section 9.3(d) [of the Credit Agreement], plaintiffs would have moving defendants potentially liable for the entire debt of up to $145 million if the Borrower is just one day delinquent in paying a dollar in property taxes or any other debt for which a lien may be imposed. Such an unlikely outcome could not have been intended by the parties, sophisticated commercial borrowers and lenders aided by competent counsel at the time of the drafting, and is impermissible under New York law. *Id.* at *5.

This case appears to be an isolated decision with bad facts, and unusual in that the court acknowledged that this was a commercial transaction in which all parties were sophisticated and represented by competent counsel. The court struggled to reconcile the conflicting non-recourse and carveout provisions in the Credit Agreement, and most likely favored the guarantors in this case because the events allegedly triggering full recourse liability were of little consequence, of short duration, and did not adversely affect the interests of the lender, whereas the consequences to the guarantors were extreme and not reasonably related to the lender's actual or anticipated damages under a liquidated-damages analysis. It will be interesting to see if any other courts follow this line of reasoning. ◆

**Nothing contained in this Article is to be considered as the rendering of legal advice for specific matters, and readers are responsible for obtaining such advice from their own legal counsel. This Article is intended for educational and informational purposes only. The views and opinions expressed in this Article are solely those of the Author, and do not necessarily reflect the views, opinions, or policies of the Author's employer, First American Title Insurance Company.* ◆

ACMA Policies and Procedures

For many years, the College has operated on the basis of various procedures and policies. Although some of these have been formally adopted and can be found in writing (e.g., the Membership Guidelines found at the back of the *Roster*), others have been informal and unwritten. Because we have followed these procedures or policies, even though perhaps with ad hoc application, the Executive Committee felt that it would be useful for the Fellows to have these policies and procedures assembled in a written form so that all Fellows can be aware of them. All of these policies and procedures can be found on the ACMA website at www.acmaatty.org.

The *TOUSA* Decision Revisited—Do Bad Facts Still Make Bad Law?

by Daniel W. Gentges[1]

I. SUMMARY OF THE TOUSA DECISIONS

A. The Rise and Fall of TOUSA Group.

TOUSA, Inc. ("TOUSA"), along with its numerous subsidiaries and affiliates (TOUSA and its subsidiaries and affiliates are referred to sometimes hereinafter generically as the "TOUSA Group"), designed, built and marketed residential properties in Florida, Texas, the mid-Atlantic states and the western United States. By 2005, the TOUSA Group was the thirteenth largest homebuilder in the United States. To finance its projects, the TOUSA Group borrowed against its significant assets, which primarily consisted of land and homes in various stages of completion.

In 2005, TOUSA formed a joint venture with another home builder for the purpose of acquiring a significant Florida-based homebuilder. The joint venture was funded in large part through a series of third party loan facilities. Shortly thereafter, the real estate market entered into recession. The joint venture defaulted on its loan obligations. The loan defaults resulted in litigation between TOUSA and the joint venture lenders.

In July 2007, TOUSA reached a settlement with the joint venture lenders, which was funded through new loans from a different lender group. Certain members of the TOUSA Group were added as subsidiary borrowers under and guarantors for the settlement loans, and also pledged their assets as security for the settlement loans, despite not being parties to the settlement.

The TOUSA Group's fortunes thereafter declined rapidly as the recession affecting the residential real estate market worsened. Ultimately, the TOUSA Group sought bankruptcy protection. The official committee representing unsecured creditors (consisting primarily of bond holders with claims against members of the TOUSA Group totaling more than $1 billion) brought an adversary proceeding against TOUSA and the joint venture lender group claiming that (1) the pledges of security by members of the TOUSA Group to the settlement lenders, and (2) the transfer of loan proceeds from the settlement lenders to the joint venture lenders, constituted fraudulent transfers under Section 548 of the United States Bankruptcy Code (the "Code").

B. The Bankruptcy Court Imposes Rough Justice.

In *Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc., (In re TOUSA, Inc.),*[2] Bankruptcy Judge John K. Olson agreed with the unsecured creditors and ordered the joint venture lenders to return more than $480 million to the bankruptcy estates of the TOUSA Group. The bankruptcy court's decision—principally, the court's findings that the settlement loan proceeds were voidable fraudulent transfers to or for the benefit of the joint venture lenders—sent shock waves through the lending community. The court's holding raised significant issues regarding the level of due diligence required by lenders who receive payment of their existing loans through refinancings, as well as the permitted scope of the business judgment of borrowers who enter into complex restructuring arrangements with both their existing lenders and those lenders providing take-out financing.

C. Upon Further Review: The District Court Reaches A Different Conclusion.

Whereas the bankruptcy court imposed heightened responsibilities on the joint venture lenders when accepting repayment, in *3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of TOUSA, Inc., (In re TOUSA, Inc.),*[3] District Court Judge Alan Gold overturned the bankruptcy court's decision. The district court's decision should provide some reassurance to lenders that they are relatively free to accept payment from a refinancing.

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1 The author is grateful to Benjamin P. Brunette, a J.D. candidate in his third year at the University of Michigan Law School, for his substantive contributions to this article.

2 422 B.R. 783 (Bankr. S.D. Fla. 2009).

3 444 B.R. 613 (S.D. Fla. 2011).

II. THE TOUSA DECISIONS ANALYZED

A. The TOUSA Group Structure.

The background circumstances of the financing arrangements for the TOUSA Group are crucial to understanding the fraudulent transfer framework reaffirmed by the *TOUSA* district court. This is particularly true considering the highly fact-specific nature of fraudulent transfer cases.

Both the bankruptcy court and the district court characterized the TOUSA Group as "a highly integrated and consolidated enterprise."[4] That high level of integration was evidenced by the prospectuses given to the bond holder-plaintiffs represented by the unsecured creditors committee. The prospectuses explained that TOUSA's ability to service its debt depended not only on its own cash flow, but also on that of the subsidiary members of the TOUSA Group. The district court noted that TOUSA's financial statements provided to the bond holders were consolidated to reflect the operations of the other members of the TOUSA Group, and "made it clear that the funds used to pay the notes would derive from the *net operations of TOUSA and its subsidiaries.*"[5]

Integration also was evidenced by the guaranties and parallel financial obligations of the TOUSA Group members. The district court characterized the TOUSA Group as an enterprise in which "the [parent]'s subsidiaries played a critical role in the vitality of the organization as a whole."[6]

Principally representative of this tightly integrated enterprise was the fact that the TOUSA Group members shared not only profits and funding availability, but debts as well. The district court pointed to a revolving credit facility (the "Revolver") TOUSA established, which was administered through Citicorp North America, Inc. ("Citicorp"). The Revolver provided credit availability to the TOUSA Group of up to $800 million; and the borrowing base for the Revolver consisted of the aggregate value of all assets held by the TOUSA Group.[7]

Finally, as discussed in greater detail below, the subsidiary members of the TOUSA Group were listed as "Subsidiary Borrowers" for the Revolver, and the TOUSA Group's assets were pledged as security for the Revolver—an arrangement that the district court found to benefit the subsidiary members of the TOUSA Group. The court noted that outside of the Revolver, "it would have been pretty close to impossible" for the subsidiary members of the TOUSA Group "to secure their own financing."[8]

B. The Transeastern Joint Venture.

In 2005, TOUSA and another homebuilder formed a joint venture (the "Transeastern J/V") for the purpose of acquiring the homebuilding assets of Transeastern Properties, Inc., a leading Florida development firm. The Transeastern J/V was funded independently from the TOUSA Group, using a combination of equity, a subordinated loan from a participating TOUSA subsidiary (Tousa Homes LP ("Tousa Homes")) and $675 million of both senior and junior third-party financing.[9] The financing was administered through Deutsche Bank Trust Company Americas ("DBTCA"). As a condition to the financing, TOUSA and Tousa Homes executed a series of joint and several completion and carve-out guaranties in favor of the Transeastern J/V lenders (the "Transeastern Lenders").

The looming recession affecting the residential real estate market soon threatened the existence of the Transeastern J/V. On September 29, 2006, the members of the Transeastern J/V entered into a "Consent and Agreement" with DBTCA, which acknowledged the occurrence of a potential default under the loan agreements with the Transeastern Lenders. On October 31 and November 1, 2006, respectively, DBTCA issued demand letters to TOUSA and Tousa Homes calling for payment of all debt under the Transeastern J/V loan agreements and the completion and carve-out guaranties.[10]

As a result of TOUSA's impending losses from the Transeastern J/V transaction, Citicorp demanded that TOUSA and the subsidiary members of the TOUSA Group provide additional security for the Revolver. In order to preserve the financing available to the TOUSA Group through the Revolver, on October 23, 2006, the subsidiary members of the TOUSA Group pledged their assets as security for the Revolver. As difficulties for the Transeastern J/V persisted, the subsidiary members of the TOUSA Group provided additional guaranties for the Revolver and agreed to be listed as "Subsidiary Borrowers" under the Revolver.[11]

The Transeastern J/V's difficulties also led to litigation among the Transeastern

4 *Id.* at 665.
5 *Id.* at 622, citing Trial Ex. 3064 at 41 (emphasis in original).
6 *Id.*
7 *See id.* at 625.
8 *Id.* at 633 (quoting Bankr. Hr'g Tr. 546:19-547:1).
9 *See id.* at 628.
10 *See id.* at 630.
11 *See id.* at 631.

Lenders, TOUSA and Tousa Homes. Through the combined effect of the Transeastern J/V loan agreements and the completion and carve-out guaranties given by TOUSA and Tousa Homes, TOUSA's management and TOUSA's financial and legal advisors estimated the litigation exposure facing TOUSA and Tousa Homes as potentially exceeding $2 billion.

At this stage, TOUSA's management faced three options: (1) proceed with litigation; (2) seek bankruptcy protection; or (3) settle with the Transeastern Lenders. TOUSA's financial and legal advisors argued in favor of settlement. The acknowledged risk of litigation was too large. A bankruptcy analysis concluded that if TOUSA sought bankruptcy protection, it may not be able to reorganize as a going concern.[12] Furthermore, a provision in the loan documents evidencing the Revolver made any judgment of $10 million or more against TOUSA or other members of the TOUSA Group an event of default. This provision raised the stakes of the Transeastern J/V litigation not just for TOUSA but for the entire TOUSA Group; as the litigation's outcome was tied directly to the TOUSA Group's only practical source of project financing.

C. The Transeastern Settlement and Subsequent TOUSA Group Bankruptcy.

TOUSA and Tousa Homes required third party financing to fund any settlement with the Transeastern Lenders. Accordingly, TOUSA borrowed $500 million from a group of lenders led by Citicorp (the "Settlement Lenders"). Under the applicable loan agreements for the settlement loans, the subsidiary members of the TOUSA Group were listed as "Subsidiary Borrowers" and pledged their assets as security.

On July 31, 2007, the litigation settlement funded. The settlement loan proceeds funded through a title company affiliate of TOUSA, which served as escrow agent. None of the settlement loan proceeds funded to or through the other members of the TOUSA Group, nor did any of the other members of the TOUSA Group have access to or control over the settlement funds.

Notwithstanding TOUSA's settlement with the Transeastern Lenders, the fortunes of the TOUSA Group continued declining. During the balance of 2007 and early into 2008, it became clear that the TOUSA Group would not survive as an enterprise. On January 29, 2008, TOUSA and most of its subsidiaries formally sought bankruptcy protection under the Code. On February 13, 2008, the United States Trustee for the Southern District of Florida appointed the Official Committee of Unsecured Creditors of TOUSA (the "Committee"). On July 14, 2008, the Committee brought the adversary proceeding described above.

The Committee's adversary complaint alleged that the settlement transaction should be avoided as a fraudulent transfer under Section 548 of the Code. Specifically, the Committee argued that the settlement loans rendered the subsidiary members of the TOUSA Group insolvent and that the subsidiaries did not receive "reasonably equivalent value" for their asset pledges to secure the settlement loans, because the loan proceeds were used to fund settlement of TOUSA's litigation with the Transeastern Lenders—litigation to which the subsidiaries were not parties and did not have a direct stake. The Committee asserted its claims on behalf of the subsidiary members of the TOUSA Group against the Transeastern Lenders; and sought recovery from the Transeastern Lenders, under Section 550 of the Code, of the settlement loan proceeds.

D. Competing Views of Fraudulent Transfer Law.

On October 30, 2009, the bankruptcy court ruled in the Committee's favor. The court held that the Transeastern Lenders were liable under Sections 548 and 550 of the Code on two different bases of liability, with respect to two distinct fraudulent transfers.

First, the court characterized the Transeastern Lenders as direct transferees of the settlement loan proceeds paid in satisfaction of the loans they had made to the Transeastern J/V. Second, the court characterized the Transeastern Lenders as entities "for whose benefit" the subsidiary members of the TOUSA Group had undertaken obligations to the Settlement Lenders and secured those obligations by pledges of their assets. At the heart of the bankruptcy court's holding was the court's finding that the TOUSA Group subsidiaries had a property interest in the settlement loans made to TOUSA and ultimately used to repay the joint venture loans made by the Transeastern Lenders. Accordingly, the bankruptcy court voided the entire settlement transaction, and ordered the Transeastern Lenders to return the settlement loan proceeds to the bankruptcy estates of the TOUSA Group subsidiaries.[13]

In contrast, the district court identified the three types of entities from whom a fraudulent transfer may be recovered

12 *See id.*

13 *See id.* at 640, 645-46.

under Section 550(a) of the Code: (1) the initial transferee; (2) the entity for whose benefit the initial transfer was made; or (3) any subsequent transferee.[14] The district court noted that Section 550 clearly separates an initial transferee of an avoidable transfer, or the entity for whose benefit the initial transfer is made, from any subsequent transferee from such initial transferee or benefited entity. The court recognized that the liability of the initial transferee or benefited entity under Section 550(a) is absolute, whereas the liability of a subsequent transferee is subject to a "good faith purchaser for value" defense under Section 550(b).[15]

1. Initial Transferee.

The district court reversed the bankruptcy court's finding that the Transeastern Lenders were direct transferees of the settlement loan proceeds from the TOUSA Group subsidiaries. In order for the Transeastern Lenders to be liable under Sections 548 and 550 as initial transferees, the TOUSA Group subsidiaries would have to have acquired a property interest in the settlement loan proceeds.[16]

Accordingly, for the transfer of the settlement loan proceeds to the Transeastern Lenders to be avoidable as a fraudulent transfer under Sections 548 and recoverable under 550, the district court noted that the transferred funds must be characterized as property of the TOUSA Group subsidiaries. The court determined that the TOUSA Group subsidiaries never held a property interest in the settlement loan proceeds.

The district court recognized the "control test" adopted in the same judicial circuit as the means by which a bankruptcy debtor's interest in property is established.[17] For transferred property to constitute property of the bankruptcy debtor, the debtor must exercise actual control over the transferred property.[18] The district court observed that TOUSA was the primary borrower with respect to the settlement loans, and the only party "with actual authority under the [settlement loan] documents," to control distribution of the settlement loan proceeds.[19] Given that the TOUSA subsidiaries never exercised control over the settlement loan proceeds, and therefore had no property interest in them, the district court concluded that the loan proceeds were not property of the TOUSA Group subsidiaries. Accordingly, the transfer of the settlement loan proceeds to the Transeastern Lenders was not recoverable as a direct transfer under Section 550(a).

2. For Whose Benefit.

As noted above, the bankruptcy court also found that because the TOUSA Group subsidiaries' guaranties of and pledges of security for the settlement loans were for the "ultimate benefit" of the Transeastern Lenders, those guaranties and related asset pledges constituted a voidable fraudulent transfer. The court characterized the Transeastern Lenders as entities for whose benefit the fraudulent transfer (i.e., the TOUSA Group subsidiaries' asset pledges in favor of the Settlement Lenders) was made.[20] The Transeastern Lenders therefore occupied both the role of the entity for whose benefit the initial transfer was made and the role of the subsequent transferee of the initial transfer (i.e., in the form of the settlement loan proceeds).

The district court observed that "a subsequent transferee cannot be the 'entity for whose benefit' the initial transfer was made."[21] The district court concluded that "the 'for whose benefit' language [contained in Section 550(a)] does not apply where the 'benefit' is not the immediate and necessary consequence of the initial transfer, but flows from the manner in which the initial transfer is *used* by its recipient—the 'benefit must derive directly from the [initial] transfer, not from the use to which it is put by the transferee.'"[22] Because the Settlement Lenders were the initial transferees of the TOUSA Group subsidiaries' asset pledges, the Transeastern Lenders could only qualify as subsequent transferees for purposes of the Section 550 recovery analysis.

3. Subsequent Transferees and Good Faith.

The bankruptcy court also characterized TOUSA's settlement payment to the Transeastern Lenders as a fraudulent transfer to a subsequent transferee, recoverable under Section 550 of the Code. The bankruptcy court held that the Transeastern Lenders had reason to know that the TOUSA Group faced dire economic straits when the settlement funded in July 2007. Accordingly, the Transeastern Lenders' acceptance of the settlement funds constituted an act of bad faith.

In overturning the bankruptcy court's

14 *See id.* at 670-71, citing 11 U.S.C. § 550(a).
15 *See id.* at 671 (case citations omitted).
16 *See id.* at 646.
17 *See id.* at 646-47, citing *Nordberg v. Societe Generale* (*In re Chase & Sanborn Corp.*), 848 F.2d 1196, 1199 (11th Cir. 1988).
18 *Id.* at 647, citing *In re Chase & Sanborn Corp.*, 813 F.2d 1177, 1181-82 (11th Cir. 19p87).
19 *Id.*
20 *See id.* at 672.
21 *Id.* at 673-74 (quoting *Bonded Fin. Serv., Inc. v. European Am. Bank*, 838 F.2d 890, 897 (7th Cir. 1998)).
22 *Id.* at 674 (quoting *Turner v. Phoenix Fin., LLC (In re Imageset, Inc.),* 299 B.R. 709, 718 (Bankr. D. Me. 2003)) (emphasis in original).

decision, the district court cited the good faith exception benefiting subsequent transferees contained in Section 550(b)(1), which precludes recovery from "a transferee that takes for value, including satisfaction… of a[n]… antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided."[23] The district court commented on the lack of any evidence introduced by the Committee to prove that the Transeastern Lenders acted in bad faith by accepting the settlement payment from TOUSA.

The court abhorred the affirmative duties such a conclusion would place on lenders attempting simply to accept payment of existing obligations. Noting that neither TOUSA nor any of the TOUSA Group subsidiaries had declared bankruptcy or made any formal step toward doing so at the time the settlement funded in July 2007, the district court refused to impose upon the Transeastern Lenders' duties to investigate the TOUSA Group's financial condition that equaled or exceeded those otherwise applicable to the Settlement Lenders.[24]

4. Reasonably Equivalent Value.

Intertwined with the questions relating to whether the Transeastern Lenders were recipients of one or more fraudulent transfers, the essential question presented to the bankruptcy court and the district court for purposes of fraudulent transfer analysis was whether the TOUSA Group subsidiaries received reasonably equivalent value in exchange for the transfers. Under certain circumstances, Section 548 of the Code permits avoidance as a fraudulent transfer of any transfer made by a bankruptcy debtor of its interest in property "if the debtor 'receive[s] less than a reasonably equivalent value in exchange for such transfer…'"[25] The Committee alleged that the TOUSA Group subsidiaries did not receive reasonably equivalent value in exchange for the transfer to the Transeastern Lenders of their property interest in the settlement loan proceeds. The Committee also alleged that the subsidiaries did not receive reasonably equivalent value in exchange for their asset pledges to support the settlement loans.

The first allegation arose in the context of the Transeastern Lenders' status as initial transferees of the settlement loan funds, which is addressed above. Because the district court determined that the TOUSA Group subsidiaries did not hold property interests in the settlement loan funds, a reasonably equivalent value test was unnecessary.

On the second allegation made by the Committee, the district court reversed the decision of the bankruptcy court, after finding that the TOUSA Group subsidiaries did in fact receive reasonably equivalent value for their asset pledges in favor of the Settlement Lenders. The district court concluded that the bankruptcy court erred by refusing to recognize as reasonably equivalent value the indirect benefits received by the TOUSA Group subsidiaries in exchange for their asset pledges in support of the settlement loans.

The district court concluded that the bankruptcy court construed the term "value" far too narrowly for purposes of determining whether the TOUSA Group subsidiaries received reasonably equivalent value for their asset pledges.[26] The bankruptcy court required the TOUSA Group subsidiaries to have received an enforceable entitlement to some form of tangible or intangible article.[27] This requirement led the bankruptcy court to hold that the avoidance of bankruptcy through the settlement arrangements with the Transeastern Lenders did not constitute sufficient value. Citing an abundance of well-established precedent, the district court rejected the bankruptcy court's holding. Instead, the district court recognized that for purposes of fraudulent transfer analysis, indirect benefits "may take many forms, both tangible and intangible."[28]

The district court examined a series of cases and legal authorities analyzing fraudulent transfer claims in the context of indirect benefits flowing to a debtor-transferor of property. The court concluded that the weight of authority supports the view that indirect and intangible economic benefits, such as "the opportunity to avoid default, to facilitate the [debtor] enterprise's rehabilitation, and to avoid bankruptcy, even if [proved] to be short lived, may be considered in determining reasonabl[y] equivalent value."[29] The court concluded that "[t]he touchstone is whether the transaction confer[s] *reasonable* commercial value on the debtor."[30] Further, "what is key in determining reasonable equivalency… is whether, in exchange for the transfer, the debtor received in return the continued opportunity to financially survive [sic], where, without the transfer, its financial demise would been [sic] all but certain."[31]

23 *Id.* (quoting 11 U.S.C. § 550(b)(1)).
24 *See id.* at 675-76.

25 *Id.* at 649 (quoting 11 U.S.C. § 548(a)(1)(B)(i)-(ii)).
26 *See id.* at 655 n.46.

27 *See id.* at 655.
28 *See id.* at 657 (quoting, e.g., *Jimmy Swaggert Ministries v. Hayes* (In re Hannover Corp.), 310 F.3d 796, 801 (5th Cir. 2002)).
29 *Id.* at 660.
30 *Id.* (emphasis on original).
31 *Id.*

- The district court recognized that the TOUSA Group subsidiaries' "very existence was contractually tied through their pre-existing guarantees [of the Revolver] to the outcome of the claims in the [Transeastern J/V] [l]itigation."[32] The court concluded that elimination of that existential threat by means of the settlement loans constituted an enormous economic benefit to the TOUSA Group subsidiaries. The fact that the settlement loans did not in fact assure the long-term viability of the TOUSA Group did not bear upon the court's reasonably equivalent value analysis. The court observed that established case law required only that the TOUSA Group subsidiaries were in a better position to remain as going concerns after the settlement loans than they would have been had the loans not been made and the Transeastern Lenders not been paid the settlement amount by TOUSA.[33]

III. CONCLUSION

The district court's emphatic rejection and overturning of the bankruptcy court's ruling in *TOUSA* removes some of the uncertainty confronting lenders immediately following the bankruptcy court's much commented upon decision. Importantly, the district court's decision confirmed the following guidelines for lenders, when considering fraudulent transfer risks under the Code:

- Fraudulent transfer inquiries remain highly fact-specific, and should be viewed under a totality of the circumstances. Particular to upstream or cross-guaranties and related pledges of collateral, the more integration between the finances of the parent and its subsidiaries, the less likely courts will find cause to intervene.
- A transfer cannot be avoided as a fraudulent transfer because it was made primarily for the benefit of a subsequent transferee. The manner in which the initial transferee uses the transferred property does not bear upon a bankruptcy court's fraudulent transfer inquiry.
- The debtor must receive some benefit from its transfer, but that benefit may be direct or indirect, and need not be materially recognized. The avoidance of an almost certain inability to operate, or the continuation of an enterprise as a going concern, will often qualify as reasonably equivalent value.
- Lenders do not have an increased responsibility of due diligence when researching debtors and their repayment of loan obligations. The measure of good faith inquiry remains unchanged. ◆

32 *Id.* at 663.
33 *See id.*

President's Column continued from page 1

into the next year. The Technology/Website/Seminar Committee has been working diligently with Bev Levy and her group to, among other things, update our website, which is scheduled for launching about the time of our Annual Meeting. We all look forward to seeing Mike Goler and his Committee's excellent work next month.

As all of you know, this year is the year for publishing the *Mortgage Law Summary*, and a special thank you to Laura McClellan and all the State Chairs and Fellows who have collaborated on the *2011–12 Mortgage Law Summary*, which should be in the mail to all our Fellows at about the time of the Annual Meeting. An informal group of three Past Presidents, Tim Konold, Bob Pinstein and Chuck Carpenter, has helped us select another former Past President, Bob Johnson, as a Lifetime Fellow. Bob is an outstanding choice, and there is an article about Bob in this edition of *The Abstract*. Special thanks to Norm Roos, Chair of the Publications Committee, who has continued to publish two excellent editions of *The Abstract* each year. Rob Krapf has continued to serve this organization with unbounded energy, and he has toiled tirelessly over many years to put our organization in great shape, including, but not limited to, compiling, writing and producing an ACMA Policy and Guideline Manual. As you can see, our Committees have been very active. I am sure that I have omitted mentioning other very active Committees and I apologize. Please advise Darlene Marsh or me if you wish to be involved in our Committees next year.

My heartfelt thanks to the Executive Committee, the Regents, the State and Provincial Chairs, the State/Provincial Chair Coordinators, the Committee Chairs, the Committee Members and all of the Fellows for their hard work on behalf of the College this year. Thanks also to Bev Levy and all of the other hardworking staff at Management Solutions Plus which has made my tenure quite enjoyable. It has been a an honor and privilege to serve all of the distinguished Fellows in ACMA and to work with such a talented group of friends. ◆

The Priorities of Proceeds and Rents

by Roger Bernhardt[1]

When the Internal Revenue Service obtains a lien against a defaulting taxpayer, the Internal Revenue Code provides that the lien is invalid against holders of security interests until the Service has filed a public notice of the lien, an awkward way of saying that that a secured party who has already filed or recorded a security interest has priority over the government's tax lien. I.R.C. § 6323(a). This is pretty much a straightforward first to file or record principle written in taxspeak.

However, the Tax Code then goes on to add, as a twist, that the security interest must be already in existence in order to have the requisite priority, which it accomplishes by providing: "A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth." § 6323(h)(1). That means that a security interest that otherwise predates a tax lien does not have priority if the collateral securing it was not also in existence before the tax lien was filed; earlier recorded secured parties do not win priority battles when after acquired collateral is involved.

How does that existence requirement play out as to rents generated under a mortgage that had been recorded *before* the tax lien was filed but that were not collected by the mortgagee until *after* the tax lien had been filed? There are fairly settled rules of priority as to rent claims in the real estate field for regularly worded mortgages[2], but neither standard mortgage law nor typical rents clauses in mortgages add an existence requirement, such as § 6323 does. The interaction of real estate law and the special tax code requirement generated a question of first impression at the federal appellate level in *Bloomfield State Bank v United States*[3], and was seized upon by Judge Posner of the Seventh Circuit as an opportunity to lecture the bar on some intriguing principles of economics.

Bloomfield State Bank v United States

In *Bloomfield*, the bank had recorded its mortgage in 2004, the IRS had filed its tax lien in 2007, and the bank had a receiver appointed in 2008, who thereafter collected some $82,000 in rents. The Service's argument that §6323(h)(1) defeated the bank's claim of priority to the rents, since they had not become "choate"[4] before the tax lien had been filed was accepted by the district court, but rejected by the Court of Appeals.

The bank's security interest in the rents was prior, according to the Seventh Circuit, because the "property" required by §6323(h)(1) to be existence is the "source of value for repaying a loan in the event of default;… not the money the lender realizes by enforcing his security interest", i.e. not the rents but the real estate. Since the real estate that generated the rents had existed (and was encumbered) before the tax lien was filed, the bank had priority notwithstanding the choateness requirement of §6323.

Giving the bank priority in these circumstances is unremarkable, and should be comforting to private real

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2 For instance, a mortgagee who has perfected its interest in the rents first has a prior claim to them—even as to rents not yet in existence—as against a mortgagee who perfected in them later (except for any rents properly collected by the second mortgagee before the first mortgagee bestirred itself into action).
The priority of mortgages against leases is an entirely separate matter, outside the scope of this column. See my column in the May 2008 California CEB Real Property Law Reporter, When First Might Be Worst, at www.RogerBernhardt.com.

3 --- F.3d ---, decided May 11, 2011,

4 Judge Posner tells us that he truly dislikes this word and intends never to have his court use it (because describing something as "choate" does not mean, as the rest of us may vulgarly suppose, that its characteristics are the opposite of "inchoate"; "inchoate" never meant "not choate", it being derived from what was, from the outset, a single integrated Latin word).
Notwithstanding this illicit provenance, I find the word, and the concept, to be useful and to permit less awkward writing. (I would not want to have to call a particular asset "uninchoate"). Therefore, with apologies to the learned judge, I will continue to employ this "c" word, consoling myself with the knowledge that some of Judge Posner's colleagues on the Seventh Circuit (including Judge Easterbrook (see U.S. v. Masters, 978 F.2d 281, 1992), and even some justices sitting on the United States Supreme Court, have committed the same linguistic sin. See U.S. v. Estate of Romani, 523 U.S. 517, 1998).

estate lenders. It means that their rights to unaccrued rents are as well protected against the IRS as they are against bankruptcy trustees. Indeed, lenders look even better armed against the IRS than against bankruptcy trustees, since Bloomfield Bank prevailed simply by virtue of having its real estate mortgage of record before the tax lien hit, whereas in bankruptcy fights, mortgagees have to rely on additional supportive federal and state legislation and the presence of complicated assignment of rents clauses (e.g., absolute but conditional on default) in their mortgages in order to shield those later rents from bankruptcy trustees.

Misgivings About the Reasoning

Nevertheless real estate lawyers might be uncomfortable with the logic driving Judge Posner's decision. It is the logic of Article 9 of the Uniform Commercial Code, written for personal property transactions, being forced onto a real estate transaction. While Article 9 might very sensibly have been applied to real estate deals, the drafters carved it out[5], and real estate judges have always preferred older and more arcane feudal property explanations for the results they reach, even when they are the same as what modern commercial judges would do.

For Judge Posner, the Bank's right to rents derived entirely from the fact that it held a security interest in the underlying collateral that generated those rents—the real estate. Rents were simply "proceeds" of that land. "[B]ecause the bank had a lien on the real estate, the rentals were proceeds." As he explains,

> "Whether the proceeds from the enforcement of a lender's lien take the form of sale income or rental income is a detail of no significance. To say that a parcel of land is "sold" rather than "rented" just means that the owner sells the use of the land forever rather than for a limited period. Sale income and rental income are just two forms of proceeds from land (or from improvements on it)."

That characterization means—for Judge Posner—that an assignment of rents clause is unnecessary, since the secured creditor has a claim on those rents anyway, as proceeds of the land. Indeed, a rents clause just confuses thinking on the issue:

> "That would have been obvious in this case had not the mortgage contained a provision stating that rental income generated by the borrower's real estate was additional collateral securing the mortgage. The makes it seem as if the rental income is a distinct form of property rather than merely proceeds of owning a rental property. *Actually the rental income provision in the mortgage is a superfluity.*"

The Role of Rents Clauses

Is an assignment of rents clause in a mortgage really superfluous? Would all results be the same with or without it? It may have once been true that a mortgagee was automatically entitled to rents merely by virtue of holding a mortgage, but that was a very long time ago. Back in the times of Glanville and Bracton and Littleton, in the twelfth, thirteenth and fourteenth centuries, when mortgage documents were gages, or terms of years that expanded into fees, or conveyances of defeasible fee estates, generating corresponding rights to possession (and before courts of chancery were interfering with legal collection efforts), it was accurate to say that the mortgagee's title to the mortgaged property entitled her to the possession of it, and thereby also entitled him to collect the rents generated from hiring out that possession to third parties.[6]

But two historical changes have made that statement inaccurate today. On the one hand, society no longer regards the collection of interest on a loan as usury per se; that ended in 1623. Creditors who had earlier been forced to demand possession in order to collect rents because it was the only way to collect the equivalent of interest on their loans[7] no longer had to use that device—they could simply loan on interest and let their debtors stay in possession. And, on the other hand, the displacement of the earlier title theory of mortgages by the more popular lien theory[8], plus the intervention of equity[9] meant that a mortgagee could not acquire possession of the premises until after it had completed a foreclosure.[10] Since the

5 So Commercial Code §9-109(d) provides "This article does not apply to… (11) the creation or transfer of a lien on real property, including a lease or rents…

6 See Burkhart, Lenders and Land, 64 Mo. L Rev. 249, 1999.

7 Which feature is what led to the labeling of these transactions as a *mort gages* rather than *vif gages* (wherein creditors collected the rents but then applied them to reduction of the debt, much less attractive than the mort gage, where they did not have credit debtors with those funds).

8 Now the accepted doctrine in most American jurisdictions, including Indiana, where Bloomfield Bank operated.

9 Denying the mortgagor the benefits of possession during the life of the mortgage comes dangerously close to impermissibly clogging his or her equity of redemption. See Shanker, Will Mortgage Law Survive?, 54 Case Western L Rev. 63, 2003.

10 Thus the Restatement of Mortgages, §4.1 provides "(a) A mortgage creates only a security interest in real estate and confers *no right to possession* of that real estate on the mortgage."
Even after a foreclosure, the mortgagee has no claim to the rents, unless it is also the foreclosure purchaser (and there is no post-sale right of redemption deferring rent collection even further).

right to rents depends on the right to possession, the lien theory effectively barricades mortgagees' claims to rents during the life of their mortgages.[11]

The Need for a Rents Clause

Given these barriers, a clause in the mortgage (or in a separate document) that provides access to rents sooner—say, on default—becomes an absolute necessity for a real estate lender. Without one, the mortgagor can stop paying the loan and pocket all of the rents (or worse, use them as a war chest to fight the mortgagee) during a prolonged foreclosure battle. The ability to write a good rents clause—one that permits enforcement immediately upon default and also makes the mortgagee's rent claims superior to those of rival mortgagees and bankruptcy trustees—has been a source of major attention by the lending industry for the past few decades.[12]

(Article 9 suffers none of these problems. Unburdened by hundreds of years of history, the drafters of the Commercial Code were able to end run the concerns that plague real estate lawyers through the concept of proceeds[13], providing that a security interest that attaches to collateral also gives the creditor the right to its proceeds[14]. As far as personal property is concerned, a creditor secured by collateral does not need to specially provide for the protection of the proceeds of that collateral.[15])

Because a secured real estate creditor is not protected by a proceeds doctrine the same way that a secured personal property creditor is, rents clauses are necessary in land mortgages. Perhaps such a clause is unnecessary to resolve a priority battle with the Internal Revenue Service, but the clause would matter when the adversary is another real estate mortgagee. Outcomes would be significantly changed where one or the other of the mortgages lacked a property rents clause.[16] (Similarly, having properly perfected the right to rents would matter very much when the lender's adversary is a bankruptcy trustee, which is why so many states—including Indiana[17], where this battle occurred—have enacted statutes designed to help lenders out in that regard.

The Uniform Assignment of Rents Act

The new Uniform Assignment of Rents Act, adopted by the Uniform Law Commission in 2005, would make significant real change in this field, including bringing the treatment of rents closer to the way Article 9 treats rents. [18] Section 4(a) of UARA provides "An enforceable security instrument creates an assignment of rents arising from the real property described in the security instrument, unless the security instrument provides otherwise." This change clearly eliminates the need to draft an assignment of rents clause, although doing so more by way of making an assignment of rents provision an implicit part of a mortgage than by way of making rents simply the proceeds of the real estate collateral.[19]

However, UARA has been enacted only in Nevada (2007) and Utah. Other rent statutes still require or, at least assume, some sort of "written assignment of

11 Comment b to the Restatement section just quoted adds, "This section does not limit the mortgagee's ability to gain access to the rents and profits of the mortgaged real estate through enforcement of a mortgage on rents agreement or to secure the appointment of a receiver. Each of those remedies should stand on their own merits, unencumbered by the implications of the title-lien theory dichotomy."

12 See, e.g., Forrester, Still Crazy After All These Years: The Absolute Assignment Of Rents In Mortgage Loan Transactions, 59 Fla. L. Rev. 487, 2007.

13 § 9-102

14 § 9-203. "As a result, a security interest in personal property collateral automatically extends to rents arising from that collateral, even if the debtor does not make an express assignment of those rents." Wilson Freyermuth, Modernizing Security in Rents: The New Uniform Assignment of Rents Act, 70 Mo.L.Rev 1, 2006. Freyermuth was the Reporter for this new Uniform Act.

15 One of Judge Posner's examples (inadvertently) illustrates these differences: "Suppose that after the tax lien in this case attached in 2007, the receiver sold the mortgaged property for $1 million. Would the IRS argue that its tax lien was prior to the bank's interest in the $1 million? Of course not; the mortgage had been issued years earlier, secured by real estate then existing." That might be true were this personal property, but, when it is real estate, I do not think that the mortgage would attach to the sales proceeds. Rather, the real property would remain encumbered by the old mortgage even though title was held by a new owner; cash paid for real estate is not generally treated as substitute security except when it is the result of eminent domain (where the government acquires both the title and the lien). Because insurance payments are not such substitute security, mortgages need to contain special provisions about those as well.

16 See Restatement of Mortgages, §4.2, illustration 4, where, when the first lender's mortgage does not cover rents but the second lender's does, the second lender prevails as to those rents. (Illustration 5 adds the feature of the first lender then foreclosing, which thereby terminates the second lender's earlier right to rents. In Illustration 6, where a first lender takes a mortgage only on rents and a second lender takes a mortgage on the title, a foreclosure sale by the second lender will convey a title to the purchaser which will be subject to the senior mortgage on rents.) It is doubtful that these examples would make any sense in a pure Article 9 analysis, such as Judge Posner employs.

17 See Indiana Code §32-21-4-2.

18 The UARA does incorporate the concept of proceeds, which it defines as "personal property that is received or collected on account of a tenant's obligation to pay rents." §2(10). That sounds close to, although not identical with treating rent as the proceeds of title or of the right to possession.'
The Act also defines rents, separately from proceeds, describing them, as "sums payable for the right to possess or occupy, or for the actual possession or occupation of, real property of another person."§2(12).
The California rents statute—Civil Code § 2938 - which first triggered action in this field in 1966, also used the term "proceeds", but meant by it only what happened to rent moneys after they had been collected.

19 The Official Comment to UARA §4 observes: "2. Rents as a distinct source of collateral…. By taking an assignment of rents, the assignee demonstrates its intention to have a lien upon all future rents arising from the real property, including those accruing prior to the completion of a foreclosure sale…"

an interest in leases, rents, issues, or profits of real estate made in connection with an obligation secured by real property."[20] Outside of Nevada, Utah, perhaps some archaic title theory courts, and perhaps also the Seventh Circuit, real estate mortgagees will not be able to reach the rents generated on their debtors' properties before foreclosure unless their loan documents include the right clauses. Simply calling those rents proceeds of the collateral real estate will not do the trick.

Is UARA Likely to Fly?

The history of real estate law is littered with the corpses of well meaning and well drafted proposed uniforms law that generated significant publicity on first appearance but then sunk quietly out of sight, with little or no legislative acceptance. (Witness the Uniform Land Transactions Act, The Uniform Simplification of Land Transactions Act, The Uniform Land Security Interests Act, and the Uniform Nonjudicial Mortgage Foreclosure Act.) Knowing that dissatisfied investors cannot just pick up their land and move it over to some other state with a more attractive legal system, there is little pressure on legislators or lawyers to argue for change from the old rules with which they are so deeply familiar (and with which lawyers from the big cities in other states are not).

It may be also be true that there is no compelling case for national uniformity in the process of collecting rents after loan defaults, given that local counsel and local receivers are often best equipped to do that job anyway. But uniform or not, UARA does an excellent job of rationalizing a very messy field. We should hope for its enactment, even if Judge Posner does not think that we need it. ◆

20 See, e.g., California Civil Code § 2938(a)(1)

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One part of the Knowledge Bank will be an area where you can access links to other ACMA Fellow blogs, as a way to keep up-to-date on their views of what's happening in the industry.

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