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Commercial Real Estate Lending in the United States

By Malcolm K. Montgomery & Lee A. Kuntz*

I. Introduction

It is said that "the more things change, the more they stay the same". Nothing could be more true of real estate finance in the United States. Financing structures and vehicles have been constantly changing over the last decade or so, while fundamental mortgage law has remained mostly the same. Over the course of the last decade, lenders have introduced new concepts and created sophisticated structures in an ever-evolving and competitive marketplace. These cutting-edge financial products must, however, be created with legal tools that are, for the most part, over 400 years old and that vary, often in dramatic and unexpected ways, from jurisdiction to jurisdiction. Contrast this to the broad range of financings secured by collateral other than real estate. The creation, perfection and enforcement of such security interests are largely governed in the United States by the Uniform Commercial Code. A comprehensive modernization of the portions of the UCC relevant to financings was enacted in all 50 states in the summer of 2001 with an effective date of July 1, 2001 in most states. Thus, this form of finance (unlike real estate finance) is governed by a substantially uniform and thoroughly modern law.

This article presents an overview of commercial real estate lending in the United States with a particular focus on concepts and principles that lenders should keep in mind to maintain a firm legal footing when structuring transactions in one of the most dynamic real estate finance marketplaces in the world.

* The authors are partners with Shearman & Sterling LLP. If you have any questions concerning this article, please contact either of them: Malcolm K. Montgomery (212.848.7587 or mmontgomery@shearman.com); Lee Kuntz (212.848.7392 or lkuntz@shearman.com).

II. General Background

A. Multiplicity of Legal Systems

In contrast to many other nations, the United States is actually an aggregation of multiple legal systems. With the exception of a few so-called uniform laws, such as the Uniform Commercial Code, we have no nationwide civil code. In fact, the laws that could be said to constitute our civil code actually overlay and even conflict with one another from jurisdiction to jurisdiction.

The basic mortgage law is essentially state law. This means that there are 50 separate, often quite different, state laws that could be applicable depending upon the situs of the mortgaged property and the law chosen to govern the transaction. There are also several state-like jurisdictions, such as the District of Columbia, which is technically a federal district, the Virgin Islands and the Commonwealth of Puerto Rico. In addition to state law, there is substantial federal law that applies to lending or to lending institutions. For banks, there is a substantial amount of federal law that regulates their lending activity. Moreover, the bankruptcy law of the United States is essentially a federal law. As discussed below, the bankruptcy law is a very important law in the practical pursuit of a lender's remedies and thus in transaction structuring and documentation. To complicate matters further, the federal judicial system has 12 so-called "circuits", each one headed by a Circuit Court of Appeals. This court is senior to the U.S. District Courts but junior to the United States Supreme Court. It is not uncommon for the Circuit Courts of Appeal to differ on substantial matters of federal law. Until such differences are resolved by the United States Supreme Court or, as happens occasionally, by new federal legislation, the application of federal law to a particular real estate financing may differ depending upon the particular circuit in which the case arises.

B. Choice of Law

The parties to a financing have significant flexibility in choosing the law that will govern the basic loan documentation although, of course, the law governing perfection of liens and remedial actions against the real property will generally have to be the law of the state in which the mortgaged property is located. Thus, it is quite customary in major loan transactions that have collateral in more than one state for the parties to elect to have New York law, which is well developed and reasonably well understood, govern the financing documents to the extent possible. However, if the lender were forced to realize upon the collateral for the loan, it would be required to pursue actions in each state in which collateral is located in accordance with the law of that state.

C. Evolution of the Law in England

The entire philosophy of the law in the United States is quite different from that in countries with civil law systems. In the United States, with some limited exceptions, we have a common law system. The basic mortgage law is an exemplar of the common law in that it is illustrative of how political and social forces lead to the development of law through judicial decision rather than legislative enactment. The essential mortgage law is approximately 400 to 500 years old and evolved in England during the period when it was changing from the feudal system. To put this in a historic perspective, at the time the mortgage law was evolving, the preponderant owners of real property in England were the Lords. In addition, the preponderant use of property was for farming purposes. These two factors had significant impact on framing the mortgage law. For example, the basic law relating to debts was within the jurisdiction of the so-called law courts, which were courts directly subordinate to the Parliament. The English system also involved equity courts, which were courts subordinate to the Chancellor in his capacity as a Chief Minister to the King. Following about one hundred years of significant inter-court rivalry, it was finally determined that the foreclosure of a mortgage was an equitable proceeding and not a legal proceeding and was thus subject to the rules of equity as determined by the Chancellor. This, of course, provided significantly greater protection to the Lords than would have been the case if mortgage foreclosure were solely subject to the law courts. Many of these equitable principles still impact the mortgage law today.

D. Evolution of the Law in the United States

Two other significant historic events have fundamentally impacted the mortgage law in the United States. First was our initial development as a country. The original colonists were often the younger sons (when rules of primogenitor still prevailed, unlanded gentry) "seeking their fortunes" in a new world and, for some "colonies", criminals. In general, the original United States was a "country of debtors". This is an often repeated theme in history books and in many of the relevant judicial decisions.

The second great historical event that reinforced the debtor-favorable provisions in United States law was the Great Depression. The events following the great Stock Market Crash led to both legislative and judicial changes to the law, many of which survive today. Examples include the laws in California and other states restricting deficiency judgments following non-judicial foreclosures of mortgages and deeds of trust. Even in a state such as New York, which is considered to be more creditor-favorable than many other states, we have laws that carefully regulate the manner in which creditors may realize upon real property security.

With that as a general background, this article will now review a number of the principal aspects of mortgage financing and the law relevant to each of these aspects. As you will see and as is typical of the common law, the parties to a mortgage financing are given significant latitude in negotiating the terms that will govern their contractual arrangement and, in commercial transactions, latitude in the actual application of the remedial law. For this reason the mortgage financing documents in the United States are significantly longer and more detailed than mortgage financing documents in many other countries. Bear in mind, however, that U.S. courts subscribe to the doctrine of “once a mortgage, always a mortgage”, and novel terms that a lender may painstakingly negotiate into mortgage financing documents will be of little or no benefit to it if contrary to inviolate tenets of the U.S. common or statutory law within which mortgage financings must exist.

III. Creating the Mortgage

A. Mortgages

Although many forms of sophisticated financings no longer rely strictly on the taking of mortgages, mortgages remain the primary security instrument of real estate finance in the United States. In simplest terms, a mortgage is a document of conveyance that creates an interest in real property intended to secure repayment of a debt or performance of an obligation. Under English law, a mortgage was originally an actual title deed that was subject to a condition subsequent – title could be redeemed by payment of the secured debt when due. Thus, the mortgagee was the actual owner of the property during the interim period. Historically, most mortgage loans were for a one-year term with repayment due after the annual harvest with the practical source of repayment being the crops or livestock on the land.

If the debt were repaid at maturity, the mortgagee’s interest in the land terminated and the mortgagor again became the title holder. If the debt were not repaid at maturity, the mortgagee’s title became absolute and the property was therefore forfeited by the mortgagor. Moreover, the law courts would strictly enforce the deadline for payment, yielding unfortunate results for those mortgagors who attempted to tender payment late. The equity courts then entered the fray and began to allow any mortgagor with a sound reason for failing to timely pay the right to recover the property by paying the debt after the maturity date. This so-called “equity of redemption” was ultimately extended to all mortgagors without reference to the merits of individual equities. As a consequence, mortgagees were left in a quandary, as the mortgagor’s right to redeem prevented the mortgagee from disposing of the property. The equity courts then came to the assistance of mortgagees by developing the concept of “foreclosure” of the equity of redemption. In other words, following a default by the mortgagor, the court would set a time period during which the mortgagor would be required to redeem or else its right to redeem would be extinguished. Modern-day foreclosure of mortgages and deeds of trust is discussed in more detail below.

B. Title vs. Lien Theory

There are now three theories as to the nature of the interest in real property created by a mortgage:

- The title theory;
- The lien theory; and
- The intermediate theory.

Some eastern states have held to original title theory, under which the mortgagee holds legal title to, and the right to possession of, the property until the mortgage is satisfied or foreclosed. However, the majority of states, particularly those in the western part of the country, have adopted the lien theory, which views a mortgage as giving a lien on mortgaged property to the mortgagee, while leaving title to property in the mortgagor until a valid foreclosure. A few other eastern states follow an intermediate theory, under which the mortgagor has the right to possession only until default and the mortgagee has the right to possession after default. A state’s theory of mortgage law will affect when the mortgagor loses the right of possession and when the mortgagee obtains the right of possession after default. Thus, while it does not have a significant effect during the term of a mortgage loan, it does affect the particular remedial approach followed in the state.

C. Deeds of Trust

As an alternative to mortgages, many states employ a deed of trust format. The deed of trust is a three-party arrangement under which the borrower (trustor) conveys its property to a third party (trustee) who holds title to the property as security for the benefit of the lender (beneficiary) to which the debt is owed. The principal distinction between the mortgage and the deed of trust in these states was that a mortgage must be foreclosed in a judicial proceeding while a deed of trust can be foreclosed judicially but also permits the lender to cause the trustee to sell the property in a public sale without a judicial proceeding. Some mortgage states have now passed laws designed to eliminate this distinction and permit such non-judicial foreclosure sales – also referred to as sales by "power of sale", and some deed of trust states permit the use of a mortgage for which judicial foreclosure is required. A listing of states and the preferred encumbrance device for each can be found in *Appendix A*.

IV. Perfecting the Mortgage

With limited exceptions, in the United States we have title recording rather than title registration. In a recording system parties may file documents on the public record indexed against a property and any subsequent purchaser receives its interest subject to whatever is recorded in the public record (and perhaps whatever the purchaser has knowledge of). In a registration system, a governmental body actually issues a certificate of title to the property which certifies to the ownership of a property and the recognized encumbrances on title. The difference between title recording and title registration is significant as in the former, except for the recording of documents, governmental authorities have essentially no involvement in property conveyancing or mortgaging.

A. Recording Statutes

State recording statutes determine the order of priority among interest holders in a mortgaged property. Interests deemed to be prior to the mortgage survive a foreclosure while interests subordinate to the mortgage are extinguished. Although the general principle is "prior in time, prior in right", recording statutes may affect the outcome of a priority dispute. There are three types of recording statutes:

- Race statutes;
- Notice statutes; and
- Race-notice statutes.

Under a race statute, priority of right is based solely on the time of recordation. Regardless of the date of purchase or mortgage and regardless of the recording party's knowledge of prior unrecorded interests in the real property, the party first recording the deed, mortgage or other instrument prevails. It is a "race" to record first. Only a few states have adopted a pure race statute.

Under a notice statute, one who fails to record an interest in real property loses priority to a subsequent holder of an interest in the real property who acquires the interest without notice of the prior unrecorded interest in the property. However, if the subsequent holder of an interest in the property has notice of the prior *unrecorded* interest in the property, the subsequent holder will be subordinate to the prior unrecorded interest. A subsequent holder is not required to record its interest to obtain priority over the prior unrecorded interest. As a practical matter, however, the interest should be recorded to prevent later holders that do not have notice from acquiring priority.

Finally, a race-notice statute gives priority to a subsequent purchaser that lacks notice of a previous sale, because of the failure of a prior purchaser to record its interest, and records first. This is the most prevalent type of statute.

The adverse consequences of all three of these statutes to a purchaser of property are avoided by the immediate recording of the interest after purchasing the property. A properly recorded conveyance operates as public or so-called "constructive" notice to any potential third party purchasers, who will be deemed to have knowledge of the conveyance for purposes of applying the recording statutes. The same general principles of priority are applicable to lienholders.

Just to confuse the determination of priority further, there are several matters that are treated differently. First, there are matters that are physically obvious, such as a road. Second, there are claims that have the benefit of so-called “superpriority” statutes, such as liens for real estate taxes. Third, there are claims with special status, such as liens for construction labor and materials.

B. The Torrens System

A few states use a Torrens system, in which evidence of ownership or title is made public by a Torrens registration certificate. The Torrens system is functionally similar to the European “cadaster” system. A Torrens registration certificate is requested and obtained through the courts by the owner. The certificate is an official determination by the court that the owner holds title. Although the Torrens system could theoretically erase the need for title insurance and recordation of the interest, banks and mortgagees typically refuse to rely on the Torrens system and require title insurance instead. The Torrens system has only seen significant use in five states (Hawaii, Illinois, Massachusetts, Minnesota and Ohio), and each of these also maintains a recording system.

C. Mortgage Recording Taxes

Although almost all states tax transfers of title (or the recording of deeds), a handful of states tax the making or recording of mortgages. These mortgage recording taxes can be substantial in amount and often result in the creation of very special deal structures intended to accommodate these taxes. For example, in New York City, where the mortgage recording tax can reach 2.75% of the principal sum secured, the tax is only applied to newly advanced funds. Thus, existing mortgages are rarely released. Rather, they are assigned to the new lender which then puts on record (and pays tax on) a new mortgage for the new funds being advanced and then consolidates the new mortgage and the old mortgage(s) into a single lien by way of a consolidated mortgage document. *Appendix A* indicates for each state whether a mortgage recordation tax is imposed.

V. Priority Issues

A. Future Advances

Although most mortgage loans contemplate a single advance at the time of the initial closing, there are circumstances in which more than one advance will be necessary. Advances made after the initial closing raise lien priority issues that require special attention. First, in many states, mortgages must clearly and explicitly state if future advances are contemplated. Some states require specific notices and disclosures. Such states may also require that the mortgage specify the absolute maximum amount of debt to be secured. These disclosures are generally sufficient to notify subsequent titleholders and lienholders that the mortgage will secure future advances. Fifteen states require specific statements in the mortgage that it secures future advances and a maximum principal balance.

Second, many states distinguish between optional and obligatory future advances to determine priority. The rule in these states is that if the advance is obligatory, it takes its priority from the date of the original recordation. However, if the advance is optional, and if the mortgagee has notice when the advance is made that a subsequent mortgagee or lienor has acquired an interest in the land, then the advance loses its priority to the intervening creditor.

Third, most states permit future advances necessary to preserve the title to the mortgaged property, the priority of the mortgage and, in some states, the integrity of the mortgaged property to have priority from the date of the original recordation.

Lastly, as noted above, most states have additional requirements in the case of construction loans.

As a general matter, issues as to future advances are resolved by requiring endorsements to the lender’s title policy (discussed below) that re-date the coverage to the date of the advance.

B. Mechanics' Liens

The first U.S. mechanics' lien law was adopted by Maryland in 1791, reportedly at the behest of Thomas Jefferson and James Madison to fuel rapid building in the new capital City of Washington. All 50 states have since enacted mechanics' lien laws. Mechanics' liens are statutory liens that give unpaid contractors, workers and material suppliers liens on the real estate that they have improved. If amounts owed to them are not paid, they may foreclose such liens to recover such amounts. The underlying rationale for the liens is to permit those whose work or materials go into an improvement to real estate (and, thus, presumptively an enhancement to value) to satisfy their unpaid bills out of that real estate.

The date of perfection determines the priority of the mechanic's lien in relation to other liens. The date of perfection of a mechanic's lien varies among states. Approximately half of the states provide that the date of perfection is the commencement of the building project. A smaller number of states take the position that the perfection date relates back to the time at which the particular lienholder began furnishing labor or material. In a few states the perfection date is the date of the construction contract. Finally, in a few other states, the date of the filing the claim is the perfection date. Thus, except in the last case, the date of perfection may relate back to an earlier period in time than the date of filing the claim and thus the mechanic's lien will "prime" (or be superior to) any interest in the property acquired by intervening purchasers, mortgagees and others. This relation back circumstance can be particularly challenging in development situations, which inherently involve substantial potential for mechanics' liens.

In some states a lien claimant can obtain a lien on construction loan money not yet disbursed by a lender. Statutes permitting this are called "Stop Notice Statutes". Although they differ in various ways, such statutes permit an unpaid mechanic or material supplier to file a notice of claim with the lender, who must then stop making advances for construction or, at a minimum, hold back an amount sufficient to cover the claim.

Mechanics' liens are heavily regulated by statute and typically require the lien claimant to follow detailed steps to perfect and enforce a lien. The statutes vary significantly from state to state and are strictly interpreted and enforced against the lien claimants. As a consequence, lien claimants often fail to properly perfect, or are unable to enforce, their liens.

VI. Title Insurance

The practical answer to the risk of loss of priority or priming liens is our title insurance system. Title insurance policies, like other insurance policies, are highly technical with exclusions from coverage, limitations and endorsements that materially affect the nature and scope of the benefits of the policies. However, in its basic form, a title insurance policy essentially insures the validity of a specified interest in a property subject to a specific list of exceptions. The insured can be the existing owner or a purchaser acquiring title to the property. In either case, an owner's policy is issued. Such policies can also be written to insure the validity of leasehold interests of tenants of the property. Alternatively, the insured can be a mortgage lender, to whom a lender's policy is issued. The lender's policy insures not only that title is what it purports to be as shown in the policy, but that the mortgage or deed of trust placed on the property is a valid first priority lien. Title insurance is very different from many other kinds of insurance. While the primary function of many other forms of insurance is to provide a financial indemnity against losses that may be incurred by reason of a future unforeseen event, the primary function of title insurance is to protect against potential losses that may be incurred by reason of what has already occurred as of the date of the policy. The protection provided under a title insurance policy also includes the costs and expenses of any litigation involving the interest insured. Title policies have a single premium payable upon issuance but remain effective so long as the insured party (or its successors) retains an interest in the property. As an added benefit to lenders, a mortgagee's policy of title insurance will provide continuing coverage following a foreclosure of the insured mortgage or the taking of a deed in lieu of foreclosure.

A. Policy Forms and Coverages

All title insurance in New York, along with most of the rest of the United States, is written on American Land Title Association (ALTA) forms of policies. However, some states such as California and Texas either permit (as in California) or require (as in Texas) the use of an alternative form. The policy forms are periodically reviewed by title industry committees, state regulators and attorneys. New York and some other states regulate title insurance rates. Other states allow the parties to negotiate the rates. Both owner's and lender's ALTA title insurance policies cover losses suffered by reason of any of the following:

- Title being vested other than as stated in the policy;
- Any defect in title or lien or encumbrance on the title (other than those identified in the policy as exceptions to title);
- Unmarketability of title;
- Lack of a right of access to and from the land; and
- Any statutory lien for services, labor or materials furnished prior to the date of the policy that has priority over the insured estate or interest.

Lender's title insurance policies also provide coverage against the following additional risks to a mortgage lender:

- Invalidity or unenforceability of the lien of the insured mortgage;
- Priority of any lien or encumbrance over the lien of the insured mortgage;
- Lack of priority of the lien of the insured mortgage over any statutory lien for services, labor or material relating to improvement work contracted for or commenced (i) prior to the date of the policy or (ii) after the date of the policy and financed by advances secured by the insured mortgage (so long as the advances were made prior to the policy date or were advances that the lender was obligated to make); and
- Invalidity or unenforceability of any assignment of the insured mortgage (from a former lender to the current lender, for example) specifically identified in the policy.

The only state in which title insurance cannot be purchased is Iowa, which permits only licensed attorneys to prepare title abstracts within the state. As a practical matter, however, this does not mean that title insurance is unavailable for Iowa properties. In lieu of setting up Iowa offices, major title insurance companies purchase the title abstracts legally prepared in Iowa and then issue policies based on them from offices in neighboring states.

B. Endorsements and Policy Exclusions

Additional coverages can be added through endorsements to the title policy, typically purchased for an extra premium. Items covered by a policy include discovery that the insured owner is not the actual owner, undiscovered encumbrances (unless identified in the policy as an exception to coverage), and prior unpaid real estate taxes. In all cases, an insured party's recoveries under a policy will be limited to the lesser of the amount of losses actually proven by the insured or the insured amount shown in the policy (usually equal to the amount of the loan or the purchase price of the insured property). No limits apply to the coverage provided for litigation costs and expenses, which are borne wholly by the title insurance company. Title policies also exclude coverage for rights of government (such as eminent domain takings) and encumbrances created after the policy date.

Because the U.S. uses title registration and title insurance rather than governmental title registration, the actual state of title to a property is rarely cleared of outdated items or extraneous claims. Rather the title insurer, based upon its own underwriting standards, insures over such items either by not excluding them from coverage or by affirmatively insuring against loss arising from such items. Although this is a widely accepted approach, some institutional lenders and investors will require that some types of items be affirmatively removed from the record.

Title insurance is a very important part of the mortgage loan process in the United States and is, in many states, a major expense. Thus, it is a process with which non-U.S. lenders should become familiar.

VII. Special Mortgage Provisions

A. Due-on-Sale and Due-on-Encumbrance Clauses

A "due-on-sale clause" provides that if the mortgagor sells the property without the mortgagee's consent, the mortgagor is in default and the mortgagee may accelerate the debt. Due-on-sale clauses have been attacked by borrowers on various grounds, including allegations that they constitute unreasonable restraints on alienation. Some states permit unfettered enforcement of due-on-sale clauses by a mortgagee. Other states require justification in order to enforce the clause, such as the purchaser's lack of creditworthiness or of property management experience. This conflict among the states was largely resolved by federal legislation that validated due-on-sale clauses for almost all commercial bank lenders.

A "due-on-encumbrance clause" permits a lender to accelerate the loan if the borrower encumbers the property in a manner that violates the clause. Enforcement of such clauses is somewhat uncertain, as little reported case law has been generated on the topic and enforcement of a particular provision would seem to turn on the specific type of encumbrance at issue and the rationale for prohibiting the type of encumbrance. Although federal legislation does not restrict enforcement of such clauses in mortgage loans covering commercial property, state law may require a showing that enforcement is reasonably necessary to protect the lender's security.

B. Non-Recourse Provisions

For decades, it has been common practice in the U.S. for commercial mortgage lenders to extend credit on a "non-recourse" basis. In other words, if the borrower defaulted, the lender's only recourse was a foreclosure sale of the mortgaged property. In contrast to a traditional loan, in which the lender could seek to enforce a deficiency judgment against the borrower's assets if the loan were not fully repaid, the borrower was contractually exculpated from personal liability for defaults such as nonpayment of principal and interest, breach of representations or violations of covenants. Over time, lenders discovered that such exculpation enabled a borrower to neglect or abandon an unprofitable property, ceding to the lender the risk that the property might be worth less than the unpaid loan amount. Lenders soon began to identify defaults that posed special risks to the lender and began to carve them out of the general non-recourse provision. Lenders reserved the right to seek personal recourse liability for these defaults.

Lenders typically provide that their loans become fully recourse and that the borrower becomes liable for repayment of the entire loan amount if certain defaults occur. These are usually defaults over which borrowers have control, and often include the following matters:

- Sale or further encumbrance of the property;
- Commencement of a voluntary bankruptcy by the borrower or a guarantor;
- Assertion by the borrower of a lender liability claim or other claim against the lender or lodging opposition to a foreclosure proceeding;
- Fraud; or
- Breach of representations or covenants regarding environmental matters.

In contrast, many carve-outs do not lead to a full loss of exculpation, but merely create liability for damages. These carve-outs are designed to protect the lender against a decline in value of the property or a diversion of revenues.

They often include:

- Failure to properly apply insurance or condemnation proceeds;
- Diversion of security deposits or prepaid rents;
- Misuse of revenue after default (whether to fund a "war chest" to be used to fuel litigation against the lender or otherwise);
- Waste, which can include, among other things, failure to maintain insurance, failure to discharge mechanics' liens, failure to maintain the property, and failure to pay real estate taxes; and
- Costs and expenses incurred by the lender in enforcement of the loan documents and exercise of remedies.

The scope of the non-recourse provisions and related carve-outs is often the centerpiece to the loan document negotiations. Given their importance, lenders and borrowers often discuss and resolve them in full at the loan application or commitment stage so that significant differences of opinion can be identified and resolved at an early stage of the transaction. From a lender's point of view, a non-recourse provision has the effect of giving the borrower the option to "sell" the property to the lender in total satisfaction of the debt if the property does not succeed. Although lenders are often ready and willing to share in the risk of loss of collateral value due to general market forces, the carve-outs to non-recourse represent the lender's attempt to shift other risks of loss back to the borrower.

Finally, lenders should keep in mind that U.S. borrowers are often structured as special purpose vehicles (discussed in more detail below) the sole asset of which may be the mortgaged property securing the loan. As a consequence, it is standard operating procedure for lenders to require credit-worthy principals of the borrower to take on personal recourse liability for the same items for which the borrower bears recourse liability under the loan documents.

C. Participating Mortgages

Participating mortgages provide additional yield to lenders via cash flow or equity participation, while reducing the risks borne by borrowers who may be uncertain of the revenue or equity appreciation a project may produce. A cash flow participation gives the lender a share of the income stream from the property, while an equity participation gives the lender a share of the proceeds from a sale or refinancing. Participating mortgages were widely used during the 1980s as a method of providing borrowers with long-term financing while providing the yield to lenders with some measure of protection against inflation. With inflationary pressures now at a historic low, participating mortgages are infrequently sought. Financing with a participating mortgage will typically reduce a borrower's need for equity capital. In addition, because the base interest rates on participating mortgages are typically set at below-market levels, borrowers may find participating mortgages attractive during high interest rate cycles. For lenders, participating mortgages offer attractive returns during higher interest rate and inflationary cycles along with a guaranteed minimum return. As with any debt/equity investment, careful attention should be paid to structuring the transaction to achieve the proper balance of interest rate and participations. Careful attention to reporting requirements is also important, as close monitoring of the project may be required to determine whether participation levels have been reached.

VIII. Mortgage Enforcement and Foreclosure

There are two types of forced sale of mortgaged property to obtain satisfaction of the secured debt: judicial and nonjudicial foreclosure. In a judicial foreclosure, the sale is authorized by a court order. The authority for a nonjudicial foreclosure sale comes from a power of sale contained in the mortgage, as authorized by statute.

A. Judicial Foreclosure

Judicial foreclosure is available in every state and is the exclusive method of real estate foreclosure in about 40% of the states. After a successful trial of the lender's petition for foreclosure, the court issues an order of judicial sale. The court order vests in the sheriff, referee or other public official the authority to conduct a public sale or auction of the property. Advantages of a judicial foreclosure include the fact that the lender obtains a court decision that finally determines the rights to the property and validates the sale. In addition, the lender may preserve its right to pursue a deficiency judgment if the sale proceeds are insufficient to repay the secured indebtedness. Disadvantages to judicial foreclosures include the fact that they are more complicated, costly and time consuming than nonjudicial foreclosures, because of the need for a trial on the issues. Moreover, the mortgagor retains the right of redemption, which for practical purposes means that the lender's right to the property is uncertain until the completion of the proceeding. As purely a rule of thumb, judicial foreclosures take, on average, approximately one year to complete assuming no substantive defenses are raised by the mortgagor and no bankruptcy proceeding is commenced prior to foreclosure.

B. Nonjudicial Foreclosure

Approximately 60% of the states permit nonjudicial foreclosure (in addition to judicial foreclosure discussed above). Nonjudicial foreclosure is permitted if the mortgage or deed of trust contains a grant of authority (a "power of sale") to conduct a public sale or auction of the real estate following the occurrence of a default. Nonjudicial foreclosure is faster and cheaper than judicial foreclosure. A nonjudicial foreclosure does not require a court finding that the lender is authorized to foreclose; however, the debtor may later challenge in court the lender's right to foreclose and the sale itself. Lenders must proceed cautiously when exercising remedies. In reaction to perceived abuses in power of sale foreclosures, some state legislatures have enacted regulatory schemes that are quite intricate and detailed. A nonjudicial foreclosure sale may eliminate the lender's right to pursue other remedies, such as a suit to enforce any deficiency remaining after the sale. In California, for example, if a lender pursues a trustee's sale, the process, if not challenged by the borrower, may take only 120 days to complete, but the lender is totally foreclosed from further action against the borrower to recover any excess of the amount of the debt over the value of the property. Some feel the prohibition of a deficiency judgment in a nonjudicial foreclosure is appropriate because the sale is not court-supervised and the property is often sold to the lender for a minimal sum. The lender may preserve its right to pursue a deficiency judgment in a judicial foreclosure but such proceedings generally take more than a year to reach judgment. In New York, whether a lender pursues judicial or non-judicial foreclosure it may seek a separate deficiency judgment by following specified procedures; however, the amount of the deficiency is determined in a separate legal proceeding and is based upon the difference between the amount of the secured indebtedness and the greater of the fair market value of the property, as determined by the court, or the amount realized upon the sale of the property. Lenders, therefore, should exercise caution in determining which method of foreclosure is best under the circumstances of each case. And if a loan is secured by properties in multiple states following conflicting rules (or worse yet, is secured by a mix of real property and personal property collateral), the choice of remedies and the order in which to pursue them can become even more complex.

C. Deed in Lieu of Foreclosure

A deed in lieu of foreclosure is an agreement whereby the borrower deeds the property to the lender in exchange for a release from liability under the mortgage and other loan documents. The advantage to the lender is that the transaction can be completed quickly, without the expense of initiating a foreclosure proceeding, without the need to contend with the objections of third parties with interests in the property (because the rights of such parties remain intact), and with little or no publicity. Risks include the possibility that the deed in lieu transaction could be challenged as a fraudulent conveyance or preference, as discussed in more detail below, or on the basis of fraud or duress. Lenders should proceed with such transactions with caution and take steps to reduce the risks by obtaining, among other things, title insurance coverage, a current appraisal of the property and a favorable settlement agreement with the borrower. The income tax and transfer tax consequences of taking a deed in lieu of foreclosure should also be carefully investigated.

D. Redemption Rights

The right of redemption is the right of the mortgagor to prevent a foreclosure sale by paying the amount due on the debt or to "redeem" (or obtain a reconveyance of title to) the foreclosed property after the foreclosure sale. Generally, all states allow the debtor to redeem property before a foreclosure sale. More than half of the states provide for a statutory right of redemption that allows for the borrower to repay the debt and recover title to the real property collateral after a foreclosure. Obviously, a right of redemption after a foreclosure sale impairs the value and marketability of the property until the redemption period ends.

The redemption period and amount to be paid to redeem property after foreclosure varies from state to state. The time period ranges from six months to two years, with one year being the most common time period. The redemption amount is usually the amount of the sales price at the forced sale, not the amount of mortgage debt as of the date of the foreclosure. Most states allow the mortgagor possession during the statutory redemption period, but a few states require a posted bond.

As discussed above, the very early mortgage law involved the actual conveyance of ownership with retention of a right to redeem title. Thus, there are also a number of other doctrines in the mortgage law that relate to preservation of the right of redemption. A prime example is the doctrine against clogging the equity of redemption. In an effort to avoid the reach of the equity courts, early mortgage lenders developed a number of techniques intended to prevent borrowers from redeeming their title. The equity courts developed a broad doctrine intended to prevent these techniques, which were said to "clog" the borrower's redemption right. Several hundred years later, modern finance transactions began to involve so-called "convertible mortgages". Modeled on convertible bonds, these loans purported to give the lender the option to acquire all or a specified portion of the ownership of the mortgaged property for an amount related to the debt. As with convertible bonds, such loans usually permitted the borrower to enjoy very favorable interest rates in exchange for the conversion right. However, convertible mortgages are a classic "clog" on the equity of redemption and thus were not broadly used except in states that passed validating legislation.

E. Receiverships

Concern over the management of mortgaged property (and its rents and revenues) by the mortgagor during the period after default and before foreclosure may prompt a mortgagee to pursue a receivership. Receiverships entail the judicial appointment of a third party (receiver) to take possession of the mortgaged property and to operate, repair, collect rents and preserve the property.

The standard for appointing a receiver varies among the states. Some states allow the appointment of a receiver on a showing that the security is inadequate to cover the debt or that a threat of waste to the property exists. Other states require both of these elements, as well as evidence that the mortgagor is insolvent. Finally, some states, such as New York, allow the appointment of a receiver as of right if the provision is made for a receiver in the mortgage loan documents, although procedurally, New York courts will not appoint a receiver unless a foreclosure action has been commenced.

A few states allow the mortgagee to take possession of the property before foreclosure without the appointment of a receiver. Mortgagees usually prefer a third party to act as receiver, however, because receivership allows the mortgagee to avoid strict accounting requirements and insulates the mortgagee from tort and related landowner liabilities. However, the receiver, if appointed, is the agent of the court and not the mortgagee. Thus, the receiver may take actions to which the mortgagee objects.

F. One Action Rule

A number of states have procedural rules that limit the remedies that may be pursued by a lender against a borrower at any one time. Most of these statutes trace their roots to the Great Depression and arose out of what were then perceived to be unwarranted actions by lenders who were prone to bring multiple actions against borrowers in order to hasten the speed of debt collection as much as possible. Thus, in New York, a mortgage lender may choose between a suit to collect the debt or a foreclosure action but cannot pursue both without special leave of the court. One action rules may force lenders to make unpalatable choices.

Some states, typified by California, go further and require not only one action but also that such action be against the security first. Thus, if a debt is secured by real property there can be only "one form of action" for the recovery of the debt and that "form of action" is specified by the statute. The California courts have gone so far as to construe "action" to include a setoff against a bank account by a bank. Thus, if a debt is secured by a deed of trust held by a bank at which the borrower maintains a deposit account, the bank may not take the funds in the borrower's account by way of setoff without forfeiting its right to the real property collateral and any deficiency claim against the borrower.

IX. Lease Financing Issues

A. Assignments of Rents

Much of the economic value of leased property lies in the income stream from the property. As a consequence, mortgagees typically want some control over that income stream. Every state permits a mortgagee to hold an assignment of rents of real property collateral. While lenders require assignments of rents as part of the loan documentation, in most circumstances they do not actually collect and apply the rents themselves. Instead, they permit the borrower to do so until a default occurs.

Thus, the legal issue is when the rights of the mortgagee are fully perfected. In the case of assignments of rents this is a two level analysis. First, there is an issue of whether the assignment of rents is an "absolute assignment" or merely a "collateral assignment". The former is not in fact absolute if, as noted above, the lender permits or "licenses back" to the mortgagor the right to collect the rents until the occurrence of an event of default under the loan documents. The latter cannot be perfected until remedial steps are taken following a default. Although this appears to be a purely technical distinction, it is critically important as a lender does not get to the second level of analysis unless it passes the first.

Second, in most cases, despite the characterization or attempted characterization of an assignment of rents as an absolute assignment, the mortgagee must take steps to actually collect and apply the rents, directly or through a receiver. While the courts generally agree that actual collection of rents by the mortgagee will "perfect" the mortgagee's interest in the rents (such that the assignment of rents could not be disregarded in a bankruptcy of the borrower), the question of what actions short of actual collection are sufficient to perfect an assignment of rents remains largely unresolved. Although there was some movement during the last down-cycle in real estate to clarify the issue of perfection of an assignment of rents for U.S. bankruptcy law purposes, it remains an issue as to which there is a difference in view among the Circuit Courts of Appeal that has not yet been resolved by the U.S. Supreme Court.

B. Lockboxes

Some lenders, particularly if the loan is to be securitized, require the debtor to pay (or cause the tenants to pay) all rents directly to an account controlled by the lender. This account is typically called a "lockbox". When the loan is made, the debtor, the lender and a depository bank enter into an agreement setting forth the order and priority of disbursements to be made from the lockbox account. Because the account is typically pledged to and controlled by the lender, the lender holds a perfected security interest in the account under the recently revised provisions of the Uniform Commercial Code. Generally lockbox agreements permit the debtor to withdraw funds to pay budgeted project expenses, to provide for debt service payments, and, so long as no default has occurred, to withdraw cash flow in excess of a negotiated “cushion” for future project expenses. The lockbox approach is intended to give the lender greater actual control over the flow of funds as well as to strengthen its legal case as to perfection of its interest in the rents.

C. Priority of Tenant Leases and “SNDAs”

In general, if a lease was created before a mortgage, the lease takes priority over the mortgage. Conversely, if the mortgage was created before a lease, the tenant’s interests can rise no higher than those of the landlord, the mortgagor.

To avoid confusion over the right of a tenant or a mortgagee to terminate a lease after a foreclosure sale, loan documents usually require each major tenant to execute a subordination, nondisturbance and attornment agreement (or “SNDA”). Such an agreement typically addresses three principal topics and several related ones. First, the tenant agrees that its lease is subordinate to the lender’s mortgage (this being the “subordination”). Second, the lender agrees that the tenant may remain in possession of its leased space after foreclosure so long as the tenant is not in default under its lease (this being the “nondisturbance”). Third, the tenant agrees to recognize the lender or its successors as the landlord upon a foreclosure (this being the “attornment”). Finally, lenders often require tenants to agree to the following items:

- That after foreclosure the lender or other successor landlord will not be liable for prior landlord defaults;
- That lease amendments are not effective without the landlord’s consent (except to the extent, if any, permitted under the loan documents);
- That during the term of the loan the tenant will give the lender notice of, and right to cure, landlord defaults under the lease;
- That the lender need not recognize any prepayment of rent made by the tenant more than one month in advance of the due date; and
- That the lender is not liable for any landlord construction obligations under the lease.

SNDAs are often heavily negotiated and a lender may not always obtain each agreement requested of a tenant, particularly if the tenant is one of the more substantial tenants of the property.

D. Ground Lease Financing

Many owners of urban properties prefer to lease rather than sell their land to avoid the capital gains taxes that would be triggered by a sale. Some developers prefer to lease rather than buy development properties as a way of obtaining long-term control of a site without the necessity of raising funds to acquire the fee interest. These “ground leases” are often structured as long-term net leases under which the tenant pays ground rent to the fee owner in exchange for almost all of the benefits and burdens of ownership, other than ownership itself. Some mortgage lenders will not accept ground leases as collateral. Other mortgage lenders will accept a ground lease as collateral, but only if the lease is determined to be “financeable” – meaning not only that the lease permits the tenant to mortgage its interest in the property, but that the terms and conditions of the lease will adequately protect the interests of the lender during the term of the loan. Although a discussion of all of the protections a lender may seek in a ground lease are beyond the scope of this article, following is a list of the more significant “leasehold mortgagee protections”:

- The lease term should be longer than the term of the loan, otherwise the collateral will cease to exist prior to the date on which the loan is fully repaid.

- The tenant should have the right to mortgage the leasehold interest without the landlord's consent.
- The leasehold mortgagee should have the right to foreclose its mortgage, take title to the ground lease, and transfer or assign the ground lease, all without the landlord's consent.
- Any mortgage on the landlord's fee estate should be subordinate to the ground lease, thereby eliminating any prospect that the ground lease may be terminated upon a foreclosure of a fee mortgage.
- If the tenant defaults, the landlord should give the leasehold mortgagee notice of the default and a reasonable opportunity to cure. If a default cannot be cured without obtaining possession of the premises, the leasehold mortgagee should be given such additional time as it may need to complete a foreclosure or otherwise obtain possession.
- If the ground lease terminates because of the tenant's default or because the tenant rejects it in a bankruptcy, then the leasehold mortgagee should have the right to obtain a new lease from the landlord upon the same terms and with the same priority as the existing lease.
- The ground lease should not be amended, modified, terminated or surrendered without the consent of the leasehold mortgagee.

The above list is only a partial listing of the many items a leasehold mortgagee and its counsel will consider. Provisions in the ground lease addressing rent, use, insurance, condemnation, subleasing, estoppel certificates, recourse liability, renewal options, and dispute resolution, among others, may also affect a lender's overall analysis of whether a ground lease is truly "financeable". These points are often covered in a heavily negotiated agreement between the mortgagee and the landlord.

X. Bankruptcy Issues

Mortgage lenders in the United States should be aware of federal bankruptcy laws, contained in the Bankruptcy Reform Act of 1978, as amended, known as the "Bankruptcy Code". The provisions of the Bankruptcy Code are supplemented by the Federal Rules of Bankruptcy Procedure, which address the procedural aspects of bankruptcy practice.

A. Automatic Stay

The filing of a bankruptcy petition operates as a stay of many actions against the debtor and the property of its bankruptcy estate. The purpose behind the automatic stay is twofold: (1) to give the debtor a "breathing spell" and (2) to stop the "race to the courthouse" among creditors so that there can be a fair, organized distribution to creditors through either reorganization or liquidation proceedings. Section 362 of the Bankruptcy Code defines automatic stay, sets forth exceptions, and outlines procedures for obtaining relief from the stay.

B. Bankruptcy Estate and "Strong-Arm" Powers

In the period just before it files for bankruptcy, a borrower may enter into a number of agreements that promise certain collection rights to its creditors – such as the granting of a lien on real estate. Under state law, those agreements are valid against the debtor as negotiated, but they are generally ineffective against competing creditors unless additional steps are taken, such as properly perfecting the lien by recording a mortgage or deed of trust. Once the borrower files for bankruptcy, the creditors want these negotiated agreements enforced to give them better collection rights against the borrower (referred to in bankruptcy as the "debtor-in-possession"). The Bankruptcy Code provisions that permit the debtor-in-possession (or trustee, if one has been appointed) to resist these agreements are collectively known as "the strong-arm clause".

When the estate is formed, the debtor-in-possession (or trustee) has the right to represent the interest of the creditors collectively. By statute, the debtor-in-possession (or trustee) is a hypothetical judgment lien creditor, a hypothetical execution creditor, and a hypothetical bona fide purchaser of real property, able to set aside any transfer of property that these creditors or purchasers could set aside. Essentially, an unperfected secured creditor is an unsecured creditor in bankruptcy. The scope of these provisions is broad, permitting the debtor-in-possession (or trustee) to avoid any transfer of property of the debtor or any obligation incurred by the debtor if one of the imputed creditors could have avoided it. For example, real estate transactions, such as mortgages, can be set aside if they would yield either to a judgment lien creditor or to a bona fide purchaser for value. The status of a debtor-in-possession or trustee as a bona fide purchaser applies even in states that do not give judgment lien creditors priority over unrecorded interests. As a practical matter, creditors claiming interests that are valid against the debtor, but are ineffective against other creditors because of defects in perfection, will lose those interests. Such creditors then join the ranks of the unsecured creditors.

C. Fraudulent Conveyances/Preferences

The Bankruptcy Code grants the debtor-in-possession (or trustee) the power to invalidate certain types of transfers of property by the borrower that were made prior to the filing of the bankruptcy petition. The most common, called preferences, are transfers (including the sale of assets and the granting of liens and security interests) made before the filing of the petition while the borrower was insolvent, other than in the ordinary course of business, to secure antecedent debt (i.e., debt pre-dating the transfer of the collateral). For this purpose, debtors in bankruptcy are presumed to have been insolvent for the 90-day period prior to the filing of the petition. If the transfer is to an "insider", generally meaning an officer, director, affiliate or other constituent of the debtor whose conduct may not be at arm's length, the "look-back" period during which such transfers can be invalidated is one year prior to the petition filing date. There are numerous exceptions to this general rule on preferences, but it is essentially intended to address the common circumstance wherein lenders seek greater security for their debts when they perceive that the debtor's financial position may be deteriorating.

Fraudulent conveyance are transfers with the intent to hinder, delay or defraud creditors or transfers for which the borrower received less than fair value and which were consummated at a time the borrower was insolvent (or would be rendered insolvent by the transfer), or which left the borrower with unreasonably small capital, or as to which the borrower intended to incur debts beyond its ability to repay. Under the Bankruptcy Code, the avoidance period for fraudulent conveyances is one year. Under applicable state fraudulent conveyance statutes, the fraudulent conveyance risk may not dissipate for as long as six years (as in New York) or more.

The application of fraudulent conveyance laws to properly conducted foreclosure sales was the focus of a longstanding disagreement among the federal circuit courts. In a 1994 decision, the Supreme Court confirmed that the amount bid at a regularly conducted and non-collusive foreclosure sale will be deemed to be the fair value necessary to survive attack as a fraudulent conveyance. This left open questions regarding the risks under fraudulent conveyance laws that a lender may face in the event of defects in the state foreclosure process or acceptance of a deed to the property from the borrower in lieu of foreclosure.

The preference and fraudulent conveyance rules play significant roles in how loan transactions are structured in the United States and, of course, in how existing loan arrangements are renegotiated.

D. Assignments of Rents and Cash Collateral

A mortgage typically provides that the mortgagee is entitled to the rents from the mortgaged property upon default by the mortgagor. The general rule, pursuant to Section 552 of the Bankruptcy Code, is that after-acquired property clauses, included in security agreements, are invalid with respect to property acquired after the commencement of the bankruptcy case. However, Section 552(b)(2) provides an exception to the general rule by giving post-petition effect to "perfected" pre-petition security interests in rents. As discussed above, perfection under state law is critical to this issue and there is a general lack of clarity on this issue.

E. Upstream and Downstream Guaranties

As noted above in the discussion of fraudulent conveyances, the granting of a mortgage (or the grant of any other security for a loan) can be voided as a fraudulent conveyance if at the time the mortgage or pledge is made the debtor is insolvent and the debtor fails to receive fair or "reasonably equivalent" value for the mortgage or grant.

Following the leveraged buy-out boom in the 1980s and the conclusion of several high profile bankruptcy cases that followed, lenders became increasingly aware of the risks associated with fraudulent conveyances when structuring guaranties. A so-called "upstream" guaranty exists when the borrower of the loan proceeds is the parent company of the mortgagor. If the borrower holds its assets through a number of single purpose vehicle subsidiaries, the lender will typically want direct liens on the assets of those subsidiaries rather than merely a pledge from the borrower of its equity interests in the subsidiaries (which would leave the lender exposed to the claims of all creditors of the subsidiaries). Thus, at the closing of the loan transaction each mortgagor subsidiary would issue a guaranty of the debt and encumber its real estate with a mortgage, but would typically receive none of the loan proceeds. Such a transaction is subject to fraudulent conveyance attack if delivery of the guaranty renders the mortgagor insolvent.

A similar risk is posed by so-called "cross-stream" guaranties in which the mortgagors are sister entities of the borrower. Determining the extent of the risk involves an assessment of the financial condition of each mortgagor at the time of the closing, including an evaluation of the amount of liability represented by the guaranty obligation given its contingent nature. One may be able to mitigate the risk that an upstream or cross-stream guaranty will be branded a fraudulent conveyance by limiting the liability of the guarantor under the guaranty.

A so-called "downstream" guaranty exists when a parent entity provides a guaranty in a loan transaction in which its subsidiary acts as the borrower. At the closing of the loan, the parent may deliver mortgages on real estate or grant security interests in other assets in support of the guaranty obligation. The downstream structure is somewhat less troubling from a fraudulent conveyance standpoint than an upstream structure because in most cases a strong argument can be made that reasonably equivalent value is given for a downstream guaranty and mortgage. Courts have accepted the proposition, for example, that delivery of downstream guaranties, mortgages and grants of security interests serve to buttress and protect the parent's existing investment in the subsidiary borrower, from which the parent obtains economic returns. And when reasonably equivalent value is given, inquiry into the degree of solvency (or lack thereof) of the mortgagor (the other condition that must be satisfied for a fraudulent conveyance to exist) becomes unnecessary.

F. Special Purpose "Bankruptcy Remote" Vehicles

As noted above, real estate owners often hold title to their properties in separate legal entities. This is done to segregate the liabilities associated with any one property from those associated with others. Thus even where a lender has full recourse to its "borrower" for repayment of a loan, the borrower's assets may consist of little more than the mortgaged property itself. As a consequence, many lenders require direct guarantees from the principals of their borrowers of the items outlined above for which their borrowers bear personal recourse liability.

More importantly perhaps, following some very difficult experiences in prior down-cycles, lenders have begun to take advantage of the use of special purpose vehicles by seeking to make it difficult for such entities to file for bankruptcy protection. Drawing upon techniques developed in the asset securitization area, lenders have begun to require that borrowers be "bankruptcy remote". Such requirements typically include restrictions on the permissible business activities of the borrower, limitations on other debt obligations, prohibitions against other liens on assets, and structuring the internal decision-making process of the entity to limit the risk of a voluntary bankruptcy filing – often accomplished through the insertion of one or more so-called “independent directors”, the consent of whom is required to file a bankruptcy petition.

G. Substantive Consolidation

Having become concerned about bankruptcy remoteness, lenders faced a whole new set of issues related to so-called “substantive consolidation”. This is a bankruptcy doctrine intended to deal with an integrated company organized in separate subsidiaries. The bankruptcy courts have the power to require that these types of companies be treated as a single enterprise for bankruptcy purposes. Notwithstanding that real estate ownership has, as noted above, historically been held in separate entities and notwithstanding that virtually all properties are freestanding enterprises, lenders worried that substantive consolidation rules would in a bankruptcy scenario force them to be involved with a commingled pool of assets and creditors. For example, a lender may make a mortgage loan to a solvent subsidiary. Thereafter, the insolvent parent entity may file a bankruptcy petition and the creditors of the bankrupt parent may seek to join the subsidiary borrower in the parent’s bankruptcy and treat the entire enterprise as a single entity. The risk of such a substantive consolidation in bankruptcy is not willingly underwritten by most lenders.

Consequently, as part of bankruptcy remoteness, lenders have sought so-called separateness covenants from borrowers. These include covenants such as:

- To maintain books and records and bank accounts separate from those of any other entity;
- To hold regular board of director or other governing body meetings and to observe all other corporate formalities;
- To hold itself out to creditors and the public as a separate and distinct legal entity;
- To prepare separate tax returns and financial statements;
- To transact all business with affiliates on an arm’s-length basis pursuant to enforceable agreements;
- To conduct business in its own name and use separate stationery, invoices and checks;
- Not to commingle its assets or funds with those of any other entity; and
- Not to assume, guarantee or pay the debts or obligations of any other entity.

Fortunately, bankruptcy judges have rarely ordered substantive consolidations, especially where lenders to the non-filing entity have relied upon the separate assets of the non-filing entity.

XI. Environmental Laws

A variety of state and federal laws impose liability for cleaning up environmental contamination of a property (sometimes referred to as a “facility”) on the current owner or operator of the facility and on any person who acted as an owner or operator of the facility at the time the contamination occurred. These laws and the requirements they impose on property owners can often overlap.

Perhaps the most well known environmental law is the federal Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”). Fortunately for mortgage lenders, CERCLA contains a “secured creditor exemption” that excludes from the definition of “owner or operator” a lender who holds indicia of ownership primarily to protect its security interest in a facility, and who does not “participate in management”. During the early 1990s some Circuit Court decisions held that lenders could be held responsible for clean-up costs under CERCLA solely be virtue of holding the unexercised capacity to affect hazardous waste disposal decisions of the borrower. In 1996, Congress clarified the law to state that participating in management means actual participation in management or operations of a facility, not the mere capacity to influence, or an unexercised right to control such decisions.

Among other things, a lender may obtain and enforce environmental covenants from the borrower, conduct or require a response action, and generally provide financial advice to the borrower in an effort to prevent or cure defaults or prevent diminution in value of a facility, all without exposing the lender to potential liability under CERCLA. A lender who acquires a property through foreclosure (or deed in lieu of foreclosure) is also protected from potential liability under CERCLA, provided that the lender did not participate in its management prior to foreclosure. The foreclosing lender must seek to sell or otherwise divest itself of the facility "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements". The lender may, however, conduct business activities, wind up operations, undertake an environmental response action or otherwise protect or preserve the facility prior to disposition, all without incurring liability under CERCLA.

XII. Other Issues/Specialized Financing Structures

A. National Flood Insurance Program

Following massive floods in 1927, private flood insurance virtually disappeared. Pressure on the government to provide flood disaster relief increased over the ensuing decades as development proliferated in known flood plains. From 1960 to 1967, flood damage totaled $8.1 billion nationwide. The U.S. Congress created the National Flood Insurance Program in 1968 in an effort to reduce the need for government-funded disaster relief by providing flood insurance at reasonable rates through a joint government-private insurance program. Due to lax compliance by lenders, the law was revised and expanded in various ways in 1973 and 1994.

The program requires federally regulated lenders to warn borrowers if structures or improvements on a mortgaged property lie within an area identified as having special flood, mudslide or flood-related erosion hazards. Such areas are typically within flood plains having a one percent or greater chance of flood occurrence in any given year (the so-called "storm of 100 year occurrence"). In such cases, if flood insurance is available in the community in which the property is located, the lender is required to make the borrower purchase flood insurance coverage and to maintain the insurance during the life of the lender's loan.

The rationale for requiring depository institutions to require borrowers to purchase flood insurance is twofold: First, it expands compliance by making depository institutions private enforcers and enlarging the insurance pool so that coverage is available at reasonable rates. Second, it induces the private sector to internalize the additional risks associated with land development in areas vulnerable to flood damage.

B. Loan Syndication

Syndication is a process by which the agent bank or a lead bank sells interests in a loan on a private (as opposed to publicly-offered) basis. Generally the purchasers are other financial institutions. Syndication has been a longstanding means for agent and lead banks to meet legal lending limits, handle increased credit requirements from major customers, manage particular and overall risk exposures, increase loan originations and create a source of enhanced fee income. More recently, syndication has assisted financial institutions in meeting capital adequacy requirements. From the purchaser's perspective, syndication has allowed access to attractive credits, given exposure into attractive markets and allowed a greater level of control over the growth of assets while allowing for management of both staff and offices. Thus, a regional bank can obtain exposure in money market cities or in non-domestic markets without hiring the necessary staff or opening offices on-site.

1. Participations and Assignments

Generally there are two basic ways of syndicating a loan: participations and assignments. In a participation the ownership of the loan remains with the seller, and the borrower is generally shielded from having any direct contact with the participant, whereas in an assignment ownership of the relevant portion of the loan is transferred outright to the purchaser, who enters into a direct relationship with the borrower as a lender. Assignments are much more common today than participations by reason of the application of the capital adequacy rules. Although assignments are less favorable to borrowers (because the borrower may be required to deal directly with multiple syndicate members as lenders), generally borrowers have been willing to permit assignments.

2. Inter-Lender Arrangements

The basic terms of the inter-lender arrangements are generally the same whether a participation or assignment format is used in a syndication. The lead bank remains in charge of the administration of the loan and will have substantial powers in that role. In assignments, the basic procedures for the administration of the loan and the inter-bank arrangements are detailed in the loan agreement, whereas in participations, these matters are dealt with in the participation agreement and thus are not transparent to the borrower whose only contractual relationship is with the lead bank. The formalities in regard to both formats have long been established in the marketplace and thus there are usually only two provisions to which significant attention is paid. The first such provision is the actions with respect to the loan that require consent of the syndicate members and the second is the standard of care required of the lead bank.

As to the consent provision, generally any restructuring of a loan (that is, change in the term, interest rate, amortization or collateral) by the lead bank requires the consent of the other syndicate members. This approach does not necessarily give the other syndicate members a role in a troubled or non-performing loan, as the lead bank is generally entitled to give default notices and often may proceed with the legal and contractual remedies relating to the loan without soliciting the approval of syndicate members. However, because troubled loans are more often restructured rather then simply enforced, as a practical matter syndicate members gain leverage when a loan becomes troubled.

As to the standard of care, the most prevalent formulation is that the lead bank must only deal with the loan as it would generally deal with other loans in its portfolio. As almost all, if not all, major loans held by banks are syndicated today, this standard is a bit circular. In addition, the lead bank is typically exonerated from its own negligence (but not from its own gross negligence or willful misconduct) in administration of the loan.

3. Contractual Relationship

In syndications, the legal relationship between the lead bank and the other syndicate members is obviously of importance. Although not extensively litigated, the courts have with consistency held that the relationship is contractual rather than fiduciary. This is a critical element because the syndication process could not function as it currently does if the lead bank had to meet the strict requirements of a fiduciary relationship. From the perspective of a co-lender or participant, this means that the consent and standard of care provisions discussed in the preceding paragraph essentially define the legal relationship between them and the lead bank.

C. Securitization of Loans

Securitization of loans is a process by which interests in loans are bundled and sold in a public or private offering. Although most purchasers are financial institutions, this process does not involve the direct contractual arrangements among the holders of the interests that syndication involves. Rather, each interest holder holds a marketable security backed by one or more loans. While securitization is driven by many of the same factors as syndication, it is also driven by the availability of funding from the public markets at favorable rates and upon terms that are often not available in the private markets. However, securitization is legally very distinct from syndication.

1. The RTC and the Securitization Market

Before discussing the securitization process, it is perhaps worthwhile briefly reviewing the history of securitized mortgages. Prior to the so-called "savings & loan crisis" in the 1980s, a public market existed for the sale of securities collateralized by large pools of residential mortgage loans, primarily those with some form of governmental guarantee or other credit support. Following the crisis and creation of the Resolution Trust Corporation (or "RTC") in 1989, the RTC, together with the bulk purchasers of the distressed debt which the RTC was disposing of, created a viable market for bonds collateralized by mortgage loans or CMBS (commercial mortgage-backed securities). The initial bonds sales were accomplished by generous direct and indirect support from the RTC; however, within a couple of years non-governmental issuances of CMBS reached a level sufficient to constitute an independent market. Over the last several years the CMBS market has evolved rapidly to encompass not only existing loans which an originating financial institution decided to securitize but also new loans originated for the very purpose of being securitized (so-called "conduit" loans as they are in the pipeline or conduit running from origination to securitization).

2. Basic Securitization Structure

The securitization process involves the transfer of loans to a special purpose vehicle (formed for the sole purpose of owning the loans and which, through various techniques discussed above, is made "bankruptcy remote"). The SPV issues a series of securities. A so-called "master servicer" is retained to service the loans and securities (that is, to collect and apply the debt service payments on the loan) and a so-called "special servicer" is retained to handle the administration of any loans that become delinquent. The full structure of a CMBS is illustrated in *Appendix B*.

3. Pricing and Ratings

A major factor in the favorable pricing of CMBS is that the securities can be issued in series which meet the financial needs of a diverse group of institutional buyers. In the main this involves creating priorities which equate rating and return. These priorities (the so-called "waterfall") rely upon the subordination of more junior securities to provide credit-enhancement to the more senior securities. A typical waterfall is illustrated in *Appendix C*. However, in order to achieve the requisite ratings, the loan pool must meet a number of criteria established by the rating agencies. These requirements substantially limit the flexibility of the originator to resolve special situations with respect to particular properties or to negotiate other provisions of the mortgage documents. Thus, in return for favorable pricing and a somewhat faster origination process, the borrower may be required to accept certain less favorable terms (including, for example, more stringent "bankruptcy remoteness" requirements, more frequent and detailed financial reporting requirements and more onerous real estate tax, insurance and replacement reserve requirements).

D. Subordinate Financing and Mezzanine Loans

1. Second Mortgages

For many years it was fairly common for a property owner to obtain additional financing beyond the amount secured by a first mortgage by granting a second mortgage on its property to a subordinate lender. During the early 1990s, many first mortgagees came to understand the complications associated with resolving troubled loans on properties subject to second mortgages. Such complications include, among others, a heightened risk of so called "cram-down" plans of reorganization in which first mortgage debt is restructured over the objection of the first mortgage lender, a diminished utility of taking a deed in lieu of foreclosure because the property remains subject to the second mortgage and a general inability to complete a workout if the second mortgage lender is in bankruptcy itself. In transactions involving the securitization of the first mortgage financing, rating agencies have been especially reluctant to permit second mortgage financing.

2. Mezzanine Loans

With second mortgages thus falling out of favor, the capital markets have seen the development of so-called "mezzanine loans". A mezzanine loan is a type of junior real estate financing that takes the form of debt but is not secured by a mortgage against the property. The term "mezzanine" literally means a level in a building below the second floor but above the ground floor. The term is apt because a "mezzanine lender" takes a position subordinate to the holder of the first mortgage financing but senior to the holders of the equity interests in the property.

Mezzanine lending relies on "structural subordination" in the entities that make up the borrowing parties. In a typical case, the mortgage borrower would be a limited partnership that owns the mortgaged property. The mezzanine borrower would be the holder of a 99% limited partnership interest in the mortgage borrower (the owner of the mortgaged property). The collateral for the mezzanine loan would be a pledge to the mezzanine lender of the limited partnership interest in the mortgage borrower. If a special purpose vehicle is established by the mezzanine borrower to act as the general partner of the limited partnership mortgage borrower, then the mezzanine lender may also receive a pledge of the equity interests in that single purpose vehicle. Such a mezzanine loan is illustrated in *Appendix D*. Because the collateral for the mezzanine loan consists of pledges of equity interests, the mezzanine lender would have no direct claim against the mortgaged property or the mortgage borrower following a default under the mezzanine loan, and no right to make a claim against either of them in the event of a foreclosure of the first mortgage.

3. Preferred Equity

Some mezzanine financings are not structured as loans at all, but instead as so-called "preferred equity". In such cases, the mezzanine investor makes a capital contribution to the mezzanine borrower in exchange for a preferred equity interest in the mezzanine borrower. Alternatively, the mezzanine investor may make a capital contribution directly to the mortgage borrower and take a preferred equity interest directly in the mortgage borrower. The mezzanine investor will then receive distributions of excess cash flow on a "preferred" basis, meaning ahead of all other equity investors. Upon a payment default, the mezzanine investor may have the right to take control of the partnership or limited liability company in which it has invested.

Transactions in the real estate market today may involve mortgage debt, multiple layers of mezzanine debt and preferred equity. If the financings are not closed simultaneously, the borrower may preserve the right to put additional layers of financing in place within agreed upon parameters.

4. Intercreditor Agreements

Mezzanine loan obligations are only repaid out of cash flow remaining after payment of mortgage loan debt service, real estate taxes, insurance premiums, operating expenses and capital expenses. As a consequence, the interests of the mortgage lender and the mezzanine lender may conflict. These potential conflicts of interest are dealt with in an intercreditor agreement negotiated between the two lenders.

A typical intercreditor agreement will, among other things, prohibit the mezzanine lender from receiving any payments under the mezzanine loan during the continuance of any default under the mortgage loan. It will also restrict the mezzanine lender from increasing or modifying the mezzanine loan without obtaining the consent of the mortgage lender. The mortgage lender may also retain approval rights or controls over the identity of any successor or replacement mezzanine lenders. In exchange, the mortgage lender will agree to give notice to the mezzanine lender of any defaults by the borrower under the mortgage loan, together with the right to cure any defaults in order to prevent foreclosure. The mezzanine lender may also seek the right, following commencement of foreclosure proceedings in respect of the mortgage loan, to purchase the mortgage loan for a price equal to all amounts then due under the mortgage loan. The mezzanine lender may also require that any increase or modification of the mortgage loan be subject to the mezzanine lender's consent. This is because the mezzanine lender may be uncomfortable subordinating to a mortgage loan in a larger principal amount or bearing interest at a higher rate. Finally, the intercreditor agreement may also address the relative rights of the two lenders in the event of a bankruptcy of the mortgage borrower. Given the importance of the matters it addresses, the intercreditor agreement is often one of the most heavily negotiated agreements in a mezzanine loan transaction.

E. Legal Opinions

It is customary in commercial mortgage loan transactions in the U.S. for the borrower's counsel to issue an opinion to the lender to the effect that the loan documents are valid and binding obligations, enforceable against the borrower in accordance with their terms. The borrower's counsel may be concerned that the loan documents (typically drafted by the lender's counsel) may contain a number of potentially unenforceable provisions and that failure to identify each such unenforceable provision may result in malpractice liability to the opining law firm. As a consequence, enforceability opinions typically contain numerous qualifications and exceptions designed to narrow the legal issues to those properly within the scope of the opinion. Against this backdrop, many bar association-sponsored reports have been issued over the years in attempts to make the opinion process more efficient. These include reports issued in New York, California, Florida, Texas, Connecticut, Maryland and Pennsylvania, and several reports issued by Sections of the American Bar Association and the American College of Real Estate Lawyers. The increased frequency with which commercial mortgage loans are now being securitized has required greater uniformity in the scope and substance of enforceability opinions.

The following topics are typically included in an enforceability opinion, although some lenders may require more extensive lists of required opinions:

- That the borrower is validly existing and in good standing;
- That the borrower has the requisite power under its organizational documents to execute, deliver and perform its obligations under the loan documents;
- That the borrower has taken all action necessary under its organizational documents and applicable law to authorize execution and delivery of, and performance of its obligations under, the loan documents;
- That the loan documents are valid and binding obligations of the borrower, enforceable in accordance with their respective terms, except as may be limited by bankruptcy, insolvency and similar laws and general principles of equity;
- That execution and delivery of the loan documents by the borrower and payment of the debt will not violate the borrower's organizational documents, breach any material agreement, violate any court order or violate any law, rule or regulation of the United States or of the state in which the opinion issuer is licensed to practice;
- That the mortgages and other security documents are in form sufficient to create valid and perfected liens in favor of the lender against the real and personal property collateral described in them; and
- That to the knowledge of the opinion issuer, the borrower is not a party to any litigation that may adversely affect the loan transaction or that would have a material adverse effect on the borrower.

XIII. Conclusion

The United States presents commercial real estate lenders with a tangled web of state and federal laws that impact, to varying degrees, the documentation of lending transactions and the remedial steps a lender may take to realize on its real estate collateral. The laws trace their roots back several hundred years to a time when syndications, securitizations, mezzanine financings and other sophisticated financing structures were never even contemplated. Nonetheless, a modern lender must pay heed to structure its financings in a manner that makes optimal use of the existing legal systems while providing maximum flexibility for the lender to pursue remedies upon default. Keeping the concepts discussed above firmly in mind will limit the risk of a lender not getting the benefit of its bargain by reason of a mismatch between the "business deal" and the legal framework within which it must fit.

If you have any questions concerning this article, please contact either of the authors listed below.

For more information on the topics covered in this article, please contact:

Malcolm K. Montgomery	Lee A. Kuntz
New York	New York
+1.212.848.7587	+1.212.848.7392
mmontgomery@shearman.com	lkuntz@shearman.com

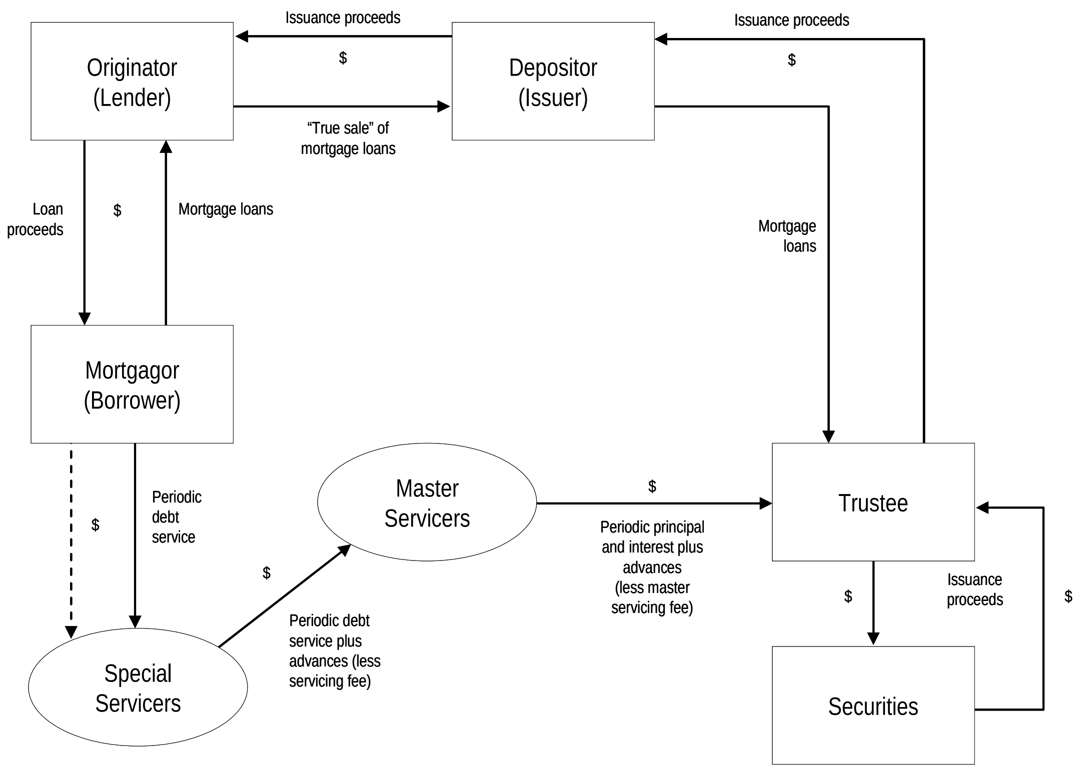
Preferred Encumbrance Devices and Mortgage Recording Taxes
(As of January 1, 2002)

State	Encumbrance Device	Mortgage Recording Tax
Alabama	Mortgage	Yes
Alaska	Deed of Trust	No
Arizona	Deed of Trust	No
Arkansas	Mortgage	No
California	Deed of Trust	No
Colorado	Deed of Trust	No
Connecticut	Mortgage Deed	No
Delaware	Mortgage	No
District of Columbia	Deed of Trust	Yes
Florida	Mortgage	Yes
Georgia	Deed to Secure Debt	Yes
Hawaii	Mortgage	Yes
Idaho	Deed of Trust	No
Illinois	Mortgage	No
Indiana	Mortgage	No
Iowa	Mortgage	No
Kansas	Mortgage	Yes
Kentucky	Mortgage	No
Louisiana	Mortgage	No
Maine	Mortgage	No
Maryland	Deed of Trust	Yes
Massachusetts	Mortgage	No
Michigan	Mortgage	No
Minnesota	Mortgage	Yes
Mississippi	Deed of Trust	No
Missouri	Deed of Trust	No
Montana	Mortgage or Deed of Trust	No
Nebraska	Deed of Trust	No
Nevada	Deed of Trust	No
New Hampshire	Mortgage	No
New Jersey	Mortgage	No
New Mexico	Mortgage or Deed of Trust	No
New York	Mortgage	Yes
North Carolina	Deed of Trust	No
North Dakota	Mortgage	No

Appendix A-2

State	Encumbrance Device	Mortgage Recording Tax
Ohio	Mortgage	No
Oklahoma	Mortgage	Yes
Oregon	Deed of Trust	No
Pennsylvania	Mortgage	No
Rhode Island	Mortgage	No
South Carolina	Mortgage	No
South Dakota	Mortgage	No
Tennessee	Deed of Trust	Yes
Texas	Deed of Trust	No
Utah	Deed of Trust	No
Vermont	Mortgage	No
Virginia	Deed of Trust	Yes
Washington	Deed of Trust or Mortgage	No
West Virginia	Deed of Trust	No
Wisconsin	Mortgage	No
Wyoming	Mortgage	No

Typical CMBS Structure



Securitization Waterfall

On each distribution date, the paying agent will apply the available distribution amount for the following purposes and in the following order of priority:

1. to the holders of the Class A-1, Class A-2 and Class X Certificates, interest in respect of each of those classes of certificates for that distribution date, *pro rata* in proportion to the interest amount payable in respect of each of those classes;
2. to the holders of the Class A-1 Certificates, principal until the aggregate certificate balance of the Class A-1 Certificates has been reduced to zero;
3. upon payment in full of the aggregate certificate balance of the Class A-1 Certificates, to the holders of the Class A-2 Certificates, principal (reduced by any principal sums distributed to the holders of the Class A-1 Certificates), until the aggregate certificate balance of the Class A-2 Certificates has been reduced to zero;
4. to the holders of the Class A and Class X Certificates, *pro rata* in proportion to their respective entitlements to reimbursement described in this clause (4), to reimburse them for any realized losses previously allocated to those classes of certificates, plus interest on those realized losses at the applicable pass-through rate;
5. to the holders of the Class B Certificates, the interest in respect of that class of certificates for that distribution date;
6. upon payment in full of the aggregate certificate balance of the Class A-2 Certificates, to the holders of the Class B Certificates, principal (reduced by any principal sums distributed to the holders of the Class A Certificates), until the aggregate certificate balance of the Class B Certificates has been reduced to zero;
7. to the holders of the Class B Certificates, to reimburse them for any realized losses previously allocated to that class of certificates, plus interest on those realized losses at the applicable pass-through rate;
8. to the holders of the Class C Certificates, interest in respect of that class of certificates for that distribution date;
9. upon payment in full of the aggregate certificate balance of the Class B Certificates, to the holders of the Class C Certificates, principal (reduced by any principal sums distributed to the holders of the Class A and Class B Certificates), until the aggregate certificate balance of the Class C Certificates has been reduced to zero;
10. to the holders of the Class C Certificates, to reimburse them for any realized losses previously allocated to that class of certificates, plus interest on those realized losses at the applicable pass-through rate;
11. to the holders of the Class D Certificates, interest in respect of that class of certificates for that distribution date;
12. upon payment in full of the aggregate certificate balance of the Class C Certificates, to the holders of the Class D Certificates, principal (reduced by any principal sums distributed to the holders of the

Class A, Class B and Class C Certificates), until the aggregate certificate balance of the Class D Certificates has been reduced to zero;

13. to the holders of the Class D Certificates, to reimburse them for any realized losses previously allocated to that class of certificates, plus interest on those realized losses at the applicable pass-through rate;
14. to the holders of the Class E Certificates, interest in respect of that class of certificates for that distribution date;
15. upon payment in full of the aggregate certificate balance of the Class D Certificates, to the holders of the Class E Certificates, principal (reduced by any principal sums distributed to the holders of the Class A, Class B, Class C and Class D Certificates), until the aggregate certificate balance of the Class E Certificates has been reduced to zero;
16. to the holders of the Class E Certificates, to reimburse them for any realized losses previously allocated to that class of certificates plus interest on those realized losses at the applicable pass-through rate;
17. to the holders of the Class F Certificates, interest in respect of that class of certificates for that distribution date;
18. upon payment in full of the aggregate certificate balance of the Class E Certificates, to the holders of the Class F Certificates, principal (reduced by any principal sums distributed to the holders of the Class A, Class B, Class C, Class D and Class E Certificates), until the aggregate certificate balance of the Class F Certificates has been reduced to zero;
19. to the holders of the Class F Certificates, to reimburse them for any realized losses previously allocated to that class of certificates, plus interest on those realized losses at the applicable pass-through rate; and
20. to make payments to the holders of the Private Certificates.

Mezzanine Loan Structure