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Article Highlights

Pillsbury Winthrop Shaw Pittman LLP

Shutting Down the Construction Project

by Robert A. James, Amy L. Pierce and Noa L. Clark

Trouble, in the form of adverse changes in financial conditions or the property marketing environment, sometimes strikes urban real estate development projects during the period between construction contract signing and completion of procurement and construction activities. In many cases, the course of action that will maximize value for all stakeholders is to allow the work to continue. Project completion will result in improvement to a base level and more security from casualty risks, as well as satisfaction of the conditions from a seller or redevelopment agency to drawdown of the land rights. But if financing for that continuation is not available, or if prospects for selling or leasing the improved property appear sufficiently bleak, the developer may reluctantly determine that the construction contracts and work should be suspended for some period of time or terminated altogether.

This article outlines significant issues that an owner should consider when suspending or terminating a California commercial construction project. Similar principles apply to projects in other states and of a residential, industrial or public nature, but the statutes and other requirements are highly technical, and the specifics of the laws and contracts should always be reviewed by counsel.

Delivering the News—Notice of Suspension or Termination

Most construction contracts include a clause conferring on the owner the right to suspend the work in whole or in part for any length of time, sometimes subject to an outside limit, as well as the right to terminate the work due to a contractor default or insolvency event or for the owner's "convenience." *See, e.g.*, AIA A201 General Conditions, Article 14. (Termination for either side's default or insolvency, and jobs where the owner and contractor have made claims against each other, are beyond this article's scope.) The notice exercising such a right naturally should include all of the information required by the clause, such as the effective date of the suspension or termination and instructions on whether subcontracts or purchase orders should be terminated or assigned to the owner or its designee.

In addition, the owner should consider addressing matters in the notice or in a letter agreement confirming the state of contractual rights and duties. For example, the owner might require delivery of design work product and a formal assignment of copyright or other rights in that design. If materials have been ordered or are in transit or stored off-site, the owner might require that the manufacturer, carrier or warehouse operator be notified of the assignment of rights in those materials and have the contractor acknowledge the ownership transfer. Moreover, policies of insurance may require actions based on the transfer of care, custody and control of the project site and materials.

The owner generally will seek an acknowledgment of the specific amount owing to the contractor and the conditions on which such amount will be paid. The remaining payment generally includes costs of work done prior to the effective date of the notice, plus reasonable costs of demobilization, termination of purchase orders and shutting down operations, and undisbursed retention for work properly completed. Some contracts provide that a termination for convenience requires payment of a portion of the fee that the contractor otherwise would have earned, while under other contracts no such additional fee is owing. The payment should be released only upon receipt of lien waivers and releases completed by the contractor and by its applicable subcontractors and vendors.

Under what circumstances should the owner suspend rather than terminate the prime contract? Suspension usually entails some carrying cost or standby and security services and some additional amounts payable to vendors and manufacturers. As these costs add up, the owner eventually will need to decide whether there are sufficient prospects of restarting the project or selling it to a buyer who wants the contracts to remain in effect.

Keeping the Contract or Subcontracts in Effect—The Prompt Payment Requirements

If the decision only is to suspend the prime contract, or to keep the subcontracts in effect, the owner will want to observe the prompt payment statutes and the applicable contractual provisions to avoid significant late payment fees and exposure to contractor or subcontractor rights to stop work or terminate its obligations. In California, the prompt payment requirements are unhelpfully scattered across the Civil Code, the Business & Professions Code, the Public Contract Code and even the Public Utilities Code. See page 5 for a chart entitled "Prompt Payment Requirements for California Private Works," which lists the principal mandates for progress and final payments to contractors and subcontractors.

The basic California rules are that an owner must pay the contractor within 30 days after receipt of a complete application for progress payment in accordance with the terms of the contract (Civil Code Section 3260.1) and must make final payment (including release of retention) to the contractor within 45 days after "completion." In the context of a suspension or termination, completion means a cessation of labor for a continuous period of 60 days or a cessation of labor for a continuous period of 30 days if the owner files a "notice of cessation" in the county land records (Civil Code Sections 3260 and 3086).

However, the exceptions to these basic rules arguably are more important than the rules themselves, especially to an owner trying to limit its exposure to unwarranted payment requests. The prompt payment timetables are not triggered until the owner receives a complete application for payment in accordance with the terms of the contract. For example, if the contract requires the contractor to submit conditional and unconditional lien waivers with each application for payment and such items are missing from the contractor's submittal, the owner is under no obligation to make the requisite payment. If the owner disputes whether an item of work was performed properly, up to 150 percent of the disputed amount may be withheld (Civil Code Sections 3260 and 3260.1).

Closing Out the Claims Exposures—Making Final Payments in Exchange for the Proper Documents

An owner suspending or terminating a project should not make final payment until and unless the contractor supplies all documentation necessary to eliminate exposure to claims of the contractor and those it hired to do the work. Unlike other areas of real property law, the lack of contractual privity is no obstacle for many construction claims. In addition to the contract law rights of the contractor, many state laws confer mechanic's lien and stop notice rights on a number of parties who directly contribute to the improvement of another's property, whether as contractor, subcontractor, supplier to a contractor or subcontractor, design professional or other services provider. An owner who fails to cut off exposure to these rights risks paying once to the contractor and then a second time to these other claimants.

The owner should have a good sense of which additional parties may be able to assert claims. In California, for example, any lien or stop notice claimant (except prime contractors, union trust funds and persons performing labor for wages) must provide the owner, the prime contractor and the construction lender (if any) with a "preliminary 20-day notice" (Civil Code Sections 3097, 3098 and 3114). A proof of service affidavit for this notice also is required (Civil Code Section 3097.1). This notice is to be provided not later than 20 days after labor, service, equipment or materials are furnished by the claimant to the project. If untimely, that claimant's lien and stop notice rights would only cover items furnished within 20 days prior to service of the notice and any time thereafter. By keeping track of the preliminary notices it receives, the owner knows which parties' releases are needed for final payment.

Shutting Down the Construction Project (continued)

A claimant that has preserved its lien rights by delivering its preliminary notice generally may file a claim of lien in the county land records within 90 days after completion of the project (Civil Code Sections 3086, 3115 and 3116). The date of "completion" is not precisely defined in the statutes, so the owner should consider filing a "notice of completion" (Civil Code Section 3093) or a "notice of cessation" (Civil Code Section 3093) in the county land records and mailing copies of that notice to those parties who filed preliminary notices (Civil Code Sections 3115 and 3116). A further benefit of recording a valid notice of completion or cessation is that claimants other than the prime contractor will have only 30 days after recordation, instead of 90 days after completion, in which to file lien claims (Civil Code Section 3116).

As of January 1, 2011, filing a mechanic's lien claim in the California county records will not be sufficient to perfect such a lien. After that date, in order to perfect a mechanic's lien right, a claimant must complete a proof of service affidavit evidencing actual service of the lien claim, along with a notice of the lien, on the owner or reputed owner of the property (amended Civil Code Section 3084). This law also contemplates that a notice of pendency (known as a "*lis pendens*"), disclosing the existence of a lawsuit to foreclose the mechanic's lien, must be recorded within 110 days after recordation of the mechanic's lien (amended Civil Code Section 3146). The changes in California's mechanic's lien laws were discussed in Pillsbury's Client Alert dated April 3, 2009, entitled "Contractors and Material Suppliers Gear Up for Possible Changes to California's Mechanics Lien Laws." To preserve a mechanic's lien right, such a foreclosure lawsuit generally must be filed in the proper court within 90 days after the lien claim is recorded.

Once the potential claimants and actual lien claimants have been identified, the suspending or terminating owner will want to specify the documents that each such claimant must complete before the owner will release final funds to the contractor. The California legislature has provided a limited set of forms in Civil Code Section 3262(d), including a "Conditional Waiver and Release Upon Progress Payment," "Unconditional Waiver and Release Upon Progress Payment," "Conditional Waiver and Release Upon Final Payment" and "Unconditional Waiver and Release Upon Final Payment." Closeout documents substantially following these forms are mandatory to evidence a claimant's waiver and release of its right to further payment from the owner or lender (in the case of the conditional forms, conditioned only on receipt by the claimant of a specified amount).

If a claimant has recorded a mechanic's lien or stop notice, the owner will want to require that the claimant deliver not only the statutory release form but also a release in a form that the county recorder will accept. (In addition, if a claimant has recorded a *lis pendens* and filed a lawsuit, the closeout package should include a recordable notice of withdrawal of *lis pendens* and dismissal of the foreclosure lawsuit with prejudice.) The owner should consult in advance with the recorder's office in the specific county, since a form accepted in one county may not be recordable in another.

Final Thoughts

The construction contract and the state statutes are not the only authorities to consult in connection with a suspension or termination of a construction project. The owner should review any applicable disposition and development agreement, loan agreement, lease or other contract that may contain an obligation to complete the work or to notify other parties of the stoppage. Permits, bonds and public improvement agreements with governments may expose the owner to forfeiture of rights or security unless the required actions are taken or the appropriate consents are provided. The owner should consider notifications to sureties, guarantors or others who have provided credit support. A federal bankruptcy filing or threatened filing by any project participant also will affect the analysis of what can and should be done to protect the owner's position.

Before or concurrently with issuing the suspension or termination notice, the owner should seek control of documents and items that may be difficult to obtain once the contractor is off the job and off the site. Possession of the relevant subcontracts, surety bonds, inspection reports and permits should be confirmed. In some cases, the owner may want to take inventory (or even a video) of the materials that have been delivered or paid for to ensure that those materials are not disposed of.

Shutting Down the Construction Project (continued)

No one is happy to stop a construction project that was everyone's dream when the contracts were signed. However, vigilance by the owner is required to make sure that the troubled job is properly closed out and claims do not become nightmares.

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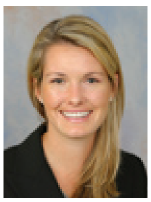

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Shutting Down the Construction Project (continued)

Prompt Payment Requirements for California Private Works

Type of Contract	Progress Payments	Final Payment (including retention)
Owner to Contractor (Civil Code §§3260, 3260.1 & 3260.2)	Basic Rule: Payment within 30 days of receipt of demand of payment in accordance with the contract. Exceptions: • Otherwise agreed to in writing. • Dispute over payment exists—in which case up to 150% of the disputed amount may be withheld. Failure to Pay: • Improperly withheld amounts subject to 2% penalty per month in lieu of interest otherwise due. • Prevailing party entitled to attorney's fees and costs. • If contractor is not paid within 35 days from when payment is due (and no dispute exists), owner is at risk of being served a 10-day stop work notice.	Basic Rule: Payment within 45 days after date of "completion." "Completion" may be issuance of a certificate of occupancy, the date of a notice of completion or actual "completion" as defined in Civil Code §3086. Exceptions: • If portion of the work ultimately will become the property of a public agency, the release of final payment may be conditioned upon acceptance by the public agency. • Dispute over payment exists—in which case up to 150% of the disputed amount may be withheld. Failure to Pay: • Improperly withheld amounts subject to 2% penalty per month in lieu of interest otherwise due. • Prevailing party entitled to attorney's fees and costs.
Contractor to Subcontractor (Civil Code §3260 and Business and Professions Code §7108.5)	Basic Rule: • Payment within 10 days of actual receipt of each progress payment. Exceptions: • Otherwise agreed to in writing. • Dispute over payment exists—in which case up to 150% of the disputed amount may be withheld. Failure to Pay: • Improperly withheld amounts subject to 2% penalty per month. • Prevailing party entitled to attorney's fees and costs.	Basic Rule: • Payment within 10 days of receipt of all or a portion of the funds by contractor. Exceptions: • If payment received by contractor is designated for a particular subcontractor, then payment must be made to the designated subcontractor. • Dispute over payment exists—in which case 150% of the disputed amount may be withheld. Failure to Pay: • Improperly withheld amounts subject to 2% penalty per month in lieu of interest otherwise due. • Prevailing party entitled to attorney's fees and costs.

Foreclosures in Washington, DC, Maryland and Virginia

by Emily K. Winton

Although many investors are optimistic about the long-term prospects for the Washington, DC, commercial real estate market, some news stories indicate that the area may need to brace for an increase in the number of distressed commercial properties in the near term. In instances where the renegotiation of financing terms with the borrower is not successful, foreclosure may be the only option for some lenders. This article briefly summarizes the steps of the foreclosure processes in the District of Columbia, Maryland and Virginia, each of which must be followed closely to ensure that sales are not delayed or overturned.

When a borrower defaults on a loan, the lender and its counsel must carefully review the loan and security documents to determine the range of the lender's potential remedies and to identify any notice and cure rights. It is common in the District of Columbia, Maryland and Virginia (each of which permits non-judicial foreclosures) for deeds of trust to contain a power of sale provision that authorizes a lender (or trustee[1]) to sell the property securing the loan following a borrower's default. In Maryland, loan documents also may contain an assent to decree provision, pursuant to which the debtor agrees in advance to the entry of a judicial decree ordering the sale of the property upon default, and the court oversees the sale. If the applicable documents do not contain a power of sale or assent to decree provision, lenders in Virginia and Maryland may seek a judicial foreclosure. Judicial foreclosures are not an option in the District of Columbia.

Once the lender has determined the proper method of foreclosure, it should send a default notice to the borrower and any guarantor specifying that the borrower is in violation of its obligations and demanding a timely cure in accordance with the applicable loan documents. A separate notice demanding full payment of the loan (i.e., an acceleration notice) should follow if the timely cure does not occur. Specific notice requirements often are set forth in the applicable loan documents and should be followed strictly to avoid challenges intended to delay the sale. If the loan documents are silent as to notice, providing default and acceleration notices to the lender's primary point of contact at the borrower at the last-known address is a strongly established—and highly recommended—custom.

Prior to initiating the actual foreclosure process, the lender needs to consider several other issues. A title search or title update on the property should be ordered to determine what encumbrances, judgments and liens affect the property. The lender also should determine whether the property is subject to any leases, and, if so, the lender should review the leases as well as any subordination, non-disturbance and attornment agreements (SNDAs) that the lender (or its predecessor) may have entered into with tenants. In all three jurisdictions, a foreclosure sale is generally subject only to those leases that (a) predate the deed of trust and (b) are not, by their terms, subordinate to the deed of trust (subordinate leases typically are terminated by virtue of the foreclosure sale[2]). Moreover, the lender should obtain and review a new or updated environmental study prior to the sale and an appraisal of the property to determine its bid strategy.

The lender must set a date for the sale and satisfy all applicable foreclosure notice and advertisement requirements. In all three jurisdictions, the lender is required by statute to provide written notice of the sale to certain parties—most importantly, the borrower and the current owner of the property (if different from the borrower)—within a specified number of days prior to the sale. Among other information, the notice must contain the time, date and place of the sale. In the District

Foreclosures in Washington, DC, Maryland and Virginia (continued)

of Columbia, a copy of the notice also must be filed with the Office of the Recorder of Deeds. It is also good practice to provide a copy to any junior lien holders, although this is statutorily required only in Maryland and merely customary in Virginia and the District of Columbia.

When determining the applicable advertising requirements, it is important to refer to the requirements contained in both the deed of trust and the applicable statutes. In Virginia, following the deed of trust requirements is sufficient so long as the advertisement runs in a newspaper having general circulation in the city or county where the property is to be sold and runs at least once per week for two weeks (if on a weekly basis) or once per day for three days (if on a daily basis). If the deed of trust is silent as to advertising requirements, the advertisement must run once per week for four weeks prior to the sale. In the District of Columbia, there is no statutorily prescribed number of times the advertisement must appear, but it is customary to run the advertisement for a total of five business days during the two-week period preceding the sale in a newspaper with wide circulation in the District of Columbia. Maryland requires that notice of the sale be published in a newspaper of general circulation in the county in which the foreclosure sale will occur once per week for three successive weeks. Regardless of jurisdiction, it is customary for the advertisement to contain the description of the property to be sold, along with the date, time and place of the sale and the terms of the sale.

If a borrower has not delayed the foreclosure by means of a temporary restraining order, bankruptcy filing or other method of keeping the property (a possibility that any foreclosing lender should prepare for), the foreclosure sale may proceed, commonly at the office of an auctioneer focused on such sales. Once the gavel falls, the sale is typically final, although occasionally it is challenged on grounds such as fraud or the lender's failure to comply with statutory foreclosure requirements. The grounds, process and time limits for challenging a foreclosure sale vary by jurisdiction. Barring a successful challenge, in the District of Columbia, Maryland and Virginia, once the sale occurs, the debtor has no right of redemption (i.e., the right to repay the defaulted loan and reclaim the property). If the proceeds from the sale do not satisfy the outstanding amount of the loan (plus the expenses of the foreclosure), however, the lender may pursue a deficiency judgment seeking a court order authorizing the lender to collect the remaining portion of the outstanding debt, unless otherwise prohibited or limited by the loan documents. The lender also may pursue any guarantor to the extent permitted by the guaranty.

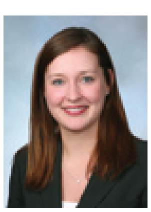
An increase in foreclosures of commercial real estate assets in the Washington, DC, area may create investment opportunities for buyers. Typically, foreclosure sales occur on an "as-is" basis, subject to any exceptions set forth in the advertisement of the foreclosure sale. Accordingly, it is crucial for potential buyers to undertake sufficient due diligence (e.g., title and survey review, environmental study, appraisal) to understand the risks involved with purchasing a foreclosure property. The potential buyer also should arrange for any necessary insurance coverage (including property and casualty, liability and title insurance) to be effective upon conveyance of title to the property in the event such buyer makes the winning bid.

Whether as seller or purchaser, lenders and investors should be aware of the foregoing issues and consult with their attorneys regarding additional statutory requirements, as well as customs and practices that affect the foreclosure sale process, all of which will become increasingly important in the coming months.

Endnotes

[1] Note that in Virginia the trustee named in the deed of trust is the administrator of the foreclosure process. It is well established under Virginia law that the trustee is the agent for both the lender and the borrower and must act with fairness and impartiality.

[2] This rule applies only to foreclosure of commercial properties. Under the Federal Protecting Tenants at Foreclosure Act of 2009, and similar statutes adopted by many states, tenants of foreclosed residential properties have greater rights.



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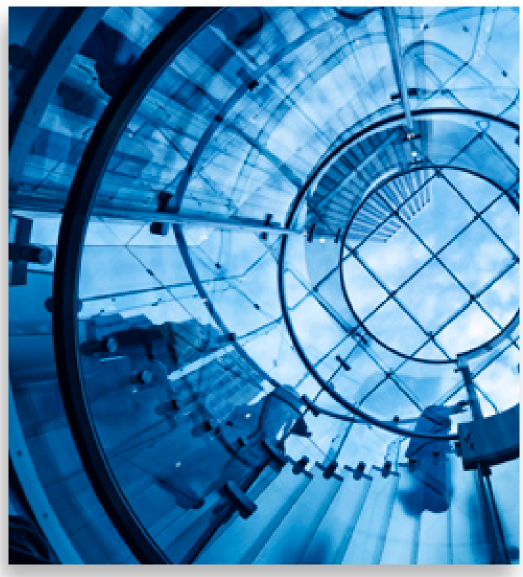
The Receiver: A Tool for Troubled Commercial Real Estate

by Christine A. Scheuneman

A receiver can be an important tool when dealing with a troubled loan or asset. A receiver is a neutral individual serving by order of a court and under that court's supervision, and often is appointed to manage real property when that property (either through its income or through the sale of the property) is to be used to satisfy a creditor's claim. The receiver's powers come from the terms of the court's appointing order and any subsequent orders and may radically affect the value and economics of the property.



The argument is sometimes made that appointing a receiver represents a draconian measure because, once appointed, the receiver divests the parties of possession and control of the property at issue. However, if parties to a troubled commercial real estate loan or investment transaction focus on using a receivership to preserve the asset and the parties' relative positions in relation to one another, a receiver may be a valuable and necessary tool to get from point A to point B. In addition, the process can facilitate a workout or foreclosure of a troubled asset. The key to a successful receivership is for the parties to handle the receivership process with the utmost care and planning and to stay involved in the process.

When a loan default occurs (or is threatened), although the parties to the transaction have obvious divergent interests, they share a common goal: to maintain the value of the property. The developer-borrower has a project that may or may not be complete, and maintaining its value depends on having the right person and professionals in charge during the receivership period. The lender has a secured interest and is precluded in many states from taking possession of the security—being a mortgagee in possession—from collecting proceeds from the operation of the property or from further collection or action of any kind. The lender, like the borrower, also is focused on recovering as much value as possible. When a receivership is contemplated, maintaining the value of the property is complicated by the fact that there will be two new outside parties in control of the asset—the receiver and the court under whose auspices the receiver serves.

This article gives a broad outline of the general procedures of a receivership to assist readers in understanding and identifying important aspects of the process that can help lead to a successful receivership.

When Trouble Begins—The Planning Process

It is important not to wait until a material default occurs to develop a plan for using a receivership since events move too quickly for effective planning at that stage. If the parties have reason to be concerned about the loan or the project, the parties should begin to consider the type of receiver who would best handle the property or asset. The parties should fully evaluate the particular skill set that the receiver will need to preserve and protect the property that secures the loan and that will be subject to the receivership. For example, if the project is an ongoing complex business such as an operating hotel, a receiver who specializes in hotel properties should be considered. The parties also should fully evaluate issues and problems that they anticipate. A common and costly mistake in choosing a receiver is simply pulling a résumé from a file and assuming that it reflects the qualifications of the receiver who should be nominated for a particular asset. Careful and confidential investigation of persons identified as potential receivers is key. The parties also should not assume that the court will take an active role in assisting the parties in choosing an appropriate receiver.

Selecting the Right Person

Selecting the receiver and drafting the appointing order carefully are the initial crucial steps in the receivership process. The parties must nominate a disinterested person with proven ability to act in the capacity of a receiver and to handle the type of property or asset that is to be placed under the receiver's control. This process is crucial, as it is very difficult for the parties to remove the receiver and appoint a new one at a later date if they are not satisfied with the performance of the receiver. In most cases, the parties may only remove an appointed receiver for gross misconduct, negligence or misappropriation of the funds of the receivership estate. Even in the face of an agreement between the borrower and lender to remove the receiver, the court may not agree.

Costs of a Receivership: Other Personnel

All property, real and personal, and all incidents of ownership are vested in the receiver. Of course, the receiver does not act alone in managing the property or asset. The appointing order routinely gives the receiver the ability to hire counsel, accountants and other professionals needed to manage the property, run the ongoing business or complete construction. The receiver charges these costs to the receivership estate, which is created upon the receiver's appointment. The court does give the parties an opportunity to be heard on the issue of which professionals the receiver hires and their compensation. The parties should take advantage of this right, since the costs of the professionals hired by the receiver will impact the economics of the property or asset. In addition, the property or asset values may be dissipated as a result of the parties' disputes. It is important for the parties to bear in mind that, as with all litigation, the more contentious the parties are with each other and the receiver, the more costs the receiver will incur in dealing with disputes. The parties should also be aware that if the project is unfinished or the funds available are not sufficient to pay receivership expenses, the lender may, but need not, advance funds. The receiver may, with court approval, borrow funds and issue receiver certificates. Those certificates operate as liens against the property and are given priority over other liens on the property—this is referred to as "priming" other liens.

Court Supervision

The primary duty of the receiver is to preserve and protect the receivership estate. Shortly after the receiver's appointment, the receiver must provide an inventory to the court of all property that is subject to his or her possession, custody and control. The court may order the parties (and any third parties) to cooperate in this process. This process also will include a preliminary accounting, and, in any case, the court will require full information as to the status of the property and regular reporting thereafter.

As mentioned above, the receiver takes no independent action outside of the court order. If the receiver acts outside of the authorization contained in the order, the receiver does so at his or her peril. Likewise, if the receiver incurs unauthorized costs, the court may not allow their reimbursement. Accordingly, when the receiver, in the exercise of his or her independent business judgment, believes that an action needs to be taken that is not specified in the court order, the receiver must ask the court to issue a subsequent order that allows the requested action. This process of asking for instructions from the court must take place each time the receiver needs additional authorization or finds the language of a prior authorization to be ambiguous. The receiver also may ask for instructions from the court when the borrower and lender (or additional parties) have a dispute over an action that needs to be taken or how the receiver's duties are to be carried out.

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Specific Projects

The appointing order also may give the receiver specific authorization to deal with the project at issue. For example, in the case of an operating hotel, the receiver may be given authorization to retain the management company in place, enter into continuation agreements with restaurant operators, deal with vendors and in all respects provide for the successful continued operation of the hotel property. If, on the other hand, the property is an unfinished construction project and the parties determine that it should be completed and marketed by the receiver, the receiver may be authorized to hire a general contractor, deal with the owners of previously sold units and otherwise complete the development.

Monitoring Status and Activities of Receiver

Inevitably, a project in receivership will have ongoing issues that must be addressed. The parties and their counsel should continuously monitor the activities of the receiver and its agents to recognize issues and ensure that there is no prejudice to the interests of the parties. For example, the receiver may not be aware that there are significant land use issues that might affect the property and the viability of a project. The parties may assist the receiver in spotting these issues and suggest solutions.

There is a fine line between taking an active role in monitoring and ensuring that all issues are addressed and assuming too great a role in management and control. Lenders in particular must beware of crossing the line and subjecting themselves to liability or compromising their ability to protect their secured position. A borrower may take the opportunity to prove that the lender is really a mortgagee in possession if the lender exerts too much control over the receivership. As a result, the lender's ability to recover the debt might be prejudiced.

Distressed Debt Acquired During Receivership

If the debt is purchased during the receivership, the purchaser of the debt will be substituted in as a party to the proceeding. It is important for the purchaser to fully assess the performance of the receiver and the economics of the receivership in order to determine whether to seek the substitution of a new receiver. Although courts are reluctant to disturb an appointed receiver, the new party may want to pursue a substitution by stipulation with the other parties and agreement with the current receiver. Again, the fine line between supervision and control must be considered.

Liquidation and Foreclosure

In cases where the secured party elects to proceed with a judicial foreclosure, a liquidating receiver may be appointed to sell the property and distribute the proceeds. This orderly liquidation process is particularly important when the lender decides to seek a judgment for the deficiency between the debt and the fair value of the property as of the date of the foreclosure sale. If the applicable state law provides for a period of redemption of the property by the borrower or an assignee of the borrower after foreclosure, the borrower will be entitled to possession of the property during the redemption period, but not to the income generated by the property. The receivership should be extended during the redemption period to ensure that all income and expenses are accounted for. At the end of the period, an accounting will be presented to the court. If redemption is sought, a proceeding will take place for the court to determine the redemption price and terms. If redemption is not sought, a final proceeding will be conducted to wind up the receivership and distribute funds.

Final Accounting and Discharge of Receiver

During the time the receiver is in place, the receiver will submit periodic (usually monthly or quarterly) reports to the court and the parties, which detail all aspects of the operation of the receivership estate. Any party may object to the contents of the report and request a hearing to ask the court to review the receiver's information and make changes in the authority or compensation of the receiver and the receiver's professionals. The parties should carefully review these reports and

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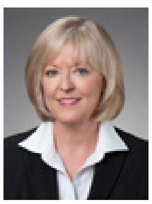
consider raising any objections immediately, since the parties may be precluded from disputing the fees and expenses when the estate is wound up at the end of the case. In addition, the parties cannot wait until the receiver submits the final report and accounting to dispute what the receiver has done or the receiver's expenses.

Before declaring a default and prior to filing any action in court, the parties should carefully review all applicable loan terms and laws applicable to the loan and location of the property to determine what procedures must be followed. The necessity of using a receiver will depend on the jurisdiction in which the subject property is located and the terms of the loan and security documents. In states in which both non-judicial and judicial foreclosures may be pursued simultaneously, the receivership is used to maintain the status quo and allow the parties time to come to a settlement, if possible. In some jurisdictions, non-judicial foreclosure is not available, and parties may only proceed through court action. The general procedures outlined in this article may be affected by local laws and procedures, as well as the practices of specific courts. The key to successfully using a receiver in any commercial real estate transaction is a full understanding of all applicable procedures and staying actively involved in all matters pertaining to the administration of the receivership.



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Planning for Valuation Issues: The Sooner, the Better

by Patrick J. Potter and Jerry L. Hall

Value is the central feature of any real estate restructuring, whether you are a debtor in need of cash, a creditor looking to recover collateral or an equity holder considering an additional investment. Because of its prevalence as a key issue, valuation is important both in and out of bankruptcy and often is the subject of disputes among parties. Further, given the uncertainty currently surrounding the value of many real estate asset classes, planning for valuation issues is critical for debtors, creditors and equity holders alike. Below is an overview of select issues where valuation often plays a significant role and considerations about valuation that may assist a party in thinking through the role valuation might play in any particular situation.

Outside of bankruptcy, the value of collateral may affect which party to a split or participated note (A/B loan), or which certificate holder of a securitization trust, is the controlling holder. The controlling holder is typically the most subordinated holder, provided it retains at least 25 percent of its original balance based on a collateral coverage analysis, taking into account real and appraisal losses (based on 90 percent of the appraised collateral value less certain charges such as servicing advances, interest accrual and the like). This determination can be significant because the controlling holder may have the right to direct, withhold consent from, and remove and replace the special servicer when the loan goes into default. A savvy junior lender will negotiate the appraisal process, events that trigger an appraisal, and appeal rights for an undesirable (i.e., low) appraisal.

Before bankruptcy, parties considering transferring certain assets out of a distressed debtor will want to ensure that the transfer consideration will withstand scrutiny if a third party challenges the transfer as fraudulent. Generally, fraudulent transfer laws require that the acquiring party give reasonably equivalent value for the asset. Valuation is thus often disputed in fraudulent transfer cases.

During bankruptcy, valuation issues appear at almost every turn. At the inception, the debtor likely will seek to use cash collateral and provide adequate protection for such use. Adequate protection is intended to ensure that a creditor's interest in the property of the debtor's estate does not decline in value. The party whose collateral will be used will want to ensure that the adequate protection actually is adequate.

An undersecured creditor in a bankruptcy is not entitled to recover post-petition interest or legal fees. Thus, a debtor may initially be interested in obtaining a low value for its property to avoid such interest and fees. As the case progresses, a debtor's interest may evolve. Valuation frequently plays a significant role when a creditor seeks relief from the automatic stay. Relief from the stay may be granted when, as an initial matter, the debtor lacks equity in the property. Whether the debtor lacks equity in the property ultimately depends upon the value of the property. Here the debtor will want a higher value or will want to ensure that other factors that would prevent a request to lift the automatic stay from being granted strongly favor the debtor.

Secured creditors have a statutory right, found at Section 1111 of the Bankruptcy Code, to decide whether to have a bifurcated claim or to have the whole claim treated as a recourse secured claim. If a secured creditor makes the so-called 1111(b)

Planning for Valuation Issues: The Sooner, the Better (continued)

election, the creditor's entire claim will be treated as secured, and the creditor will be entitled to recover full payment of the value of the collateral upon confirmation of a plan of reorganization and the nominal dollars (not present value) constituting the unpaid balance of the claim. If a secured creditor does not make the 1111(b) election, the creditor will receive a deficiency claim for the amount of the claim exceeding the value of the collateral and will be entitled to a ratable distribution from the pool of assets used to pay unsecured creditors. A secured creditor may be inclined to make the 1111(b) election where the value of the real property is significantly less than the loan balance (as often has been the case recently). Making the election could give the secured creditor additional negotiating leverage, because it could force the debtor to propose a plan of reorganization with a lengthy repayment schedule that a court would not approve. For example, the secured creditor with a $100 million claim and collateral worth $60 million would force the debtor to propose a plan to repay the secured creditor deferred cash payments equaling $100 million and having a present value of $60 million at the time the plan is confirmed. A court may not be willing to stretch repayment of $100 million over the amount of time the debtor would need, thus giving the secured creditor a measure of leverage over the debtor.

Valuation methods and the factors affecting valuation are also important considerations to keep in mind. Parties should assess which valuation method is most beneficial. (A proper appraisal should consider all methods.) Market-based valuations are the most difficult to overcome and, when time and the strategy permit, should be undertaken. For example, in the case of fraudulent transfer litigation, being able to demonstrate that the transfer consideration is consistent with or exceeds that which was offered by the marketplace likely would result in a successful defense of the transaction. Other methods of valuation may be useful as well, such as discounted cash flow, comparable sales or cost to build. Because parties will be dealing in distress situations, however, the various methods of valuation may require adaptations or accommodations.

Many factors common in distress situations are particular to the debtor. The debtor's business model may have structural shortcomings requiring significant overhaul (indeed, the liquidation value of the debtor may exceed its enterprise value). The debtor may have deferred capital improvements to meet debt service or may have reduced its budget during the distress period. Cuts to the marketing budget may adversely affect the debtor's current competitive position, and the debtor's ability to compete may otherwise be greater than it appears. The cost of replacing or retaining key employees also may be significant. Other factors are broader and not debtor-specific. For example, the state of the industry may affect the availability of capital, which in turn could affect value and possibly the debtor's prognosis. An example of this would be the telecommunications industry, which suffered broad declines in value when the capital markets dried up.

Lastly and perhaps most importantly, parties should ensure that they are working with the best available information. While a back-of-the-envelope analysis may help identify issues, valuation ultimately rests upon the details. Thus, parties should keep current on any rights they have to receive financial and related information about the debtor and its assets. These rights are particularly helpful in cases where litigation occurs. Parties in litigation rarely turn over information freely, and the more knowledge a party has before litigation begins the better that party will be able to determine what additional information is important and what litigation course to pursue.

Regardless of the particular issue or context, valuation is an important part of the distressed asset landscape, and those who fail to account for it early may struggle with their restructuring or asset disposition strategy. Conversely, those who focus on valuation from the beginning will develop sounder strategies and may be able to position themselves favorably as restructuring progresses.

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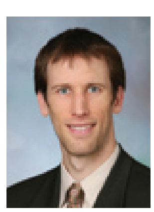

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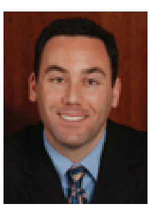
Pillsbury Creates a Real Estate Deal Out of Bankruptcy

By Craig A. Barbarosh and Jan Harris Cate

Over the winter, Pillsbury represented a Chinese investment group in its acquisition of 5,000 apartment units in Texas and Maryland. The purchase closed in January 2010 and resulted in the client acquiring the assets at a significant discount through a confirmed Plan of Reorganization in the prior owners' Chapter 11 bankruptcy proceedings.

The prior owners' defaulted loans consisted of multiple layers of notes, including a senior securitized note and junior notes held by major real estate investment firms. Pillsbury assisted the client in negotiating discounted purchases of existing debt from certain investors, then converting that debt to equity in the bankruptcy proceeding, with the client ultimately assuming the remaining commercial mortgage-backed securities (CMBS) debt at favorable restructured terms designed to allow the client to rehabilitate the projects over time.

Pillsbury's team relied on experience in the insolvency and restructuring, real estate, finance and securitization areas to close the transaction, which represents one of the largest multifamily transactions completed in the past 12 months, and one of the first since the start of the 2008 recession in which a buyer used the bankruptcy process to restructure CMBS debt and concurrently acquire a substantial commercial real estate asset.



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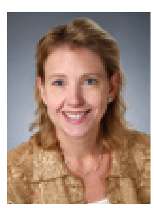

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Farewell to the ALTA Creditors' Rights Endorsement Form

By Rhina M. Roberts

Real estate lenders and owners who ask for an American Land Title Association (ALTA) 21-06 Creditors' Rights Endorsement to a title insurance policy should be prepared for rejection. On February 3, 2010, the ALTA Board of Governors recommended the decertification of the endorsement form, and decertification became final on March 8, 2010, after a 30-day comment period. This decision was spurred by several factors, including the unavailability of the endorsement in several states and the changed economic climate, which made underwriting more challenging.

Although ALTA discarded the form, the ALTA Board's recommendation expressly notes that it does not affect each title insurer's ability to decide what coverage, if any, may be provided. So although First American Title Insurance Company and Fidelity National Title Group, for example, announced shortly after decertification that they no longer will issue the endorsement, other companies (such as Stewart Title Guaranty Company, which as of this writing provides the endorsements at a rate of $1.00 per $1,000 in certain states such as Maryland, the District of Columbia, Illinois and Massachusetts) may provide coverage as a matter of policy or on a case-by-case basis (though, most likely, at a stiff premium and subject to possible additional fees).

What does this mean for owners and lenders? The creditors' rights endorsement provided affirmative coverage "against the loss or damage sustained by the insured by reason of the avoidance in whole or in part, or a court order providing some other remedy, based on the voidability of any estate, interest, or insured mortgage because of the occurrence on or before the date of policy of a fraudulent transfer or a preference under federal bankruptcy, state insolvency, or similar creditors' rights laws." Thus, eliminating the endorsement shifts to owners and lenders the risk that the insured transaction (or any prior transaction) constitutes a fraudulent or preferential transfer.

Without the protection of the endorsement, owners and lenders must increase their related due diligence efforts. Each buyer should consider negotiating tougher representations and indemnities regarding the seller's financial condition in the purchase and sale agreement and comparing a current appraisal of the real property interest against the set purchase price to ensure that the property is not being conveyed for an amount that would be deemed as significantly less than fair market value. Lenders, on the other hand, have a longer list of items to evaluate, such as the borrower ownership structure and bankruptcy-related due diligence issues.

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Lender Liability Case Law Update

By Wendelin A. White and Susan E. Michelich

The Winter 2009 edition of Pillsbury's *Perspectives on Real Estate* featured an article entitled "The New Commercial Real Estate Loan Reality: Breaking Up is Hard to Do," which discussed the recent uptick in lender liability lawsuits. The article included a description of two such lawsuits. Below is an update on the status of those lawsuits.

Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

Destiny, the developer of a major expansion of the Carousel Center shopping mall in Syracuse, New York, sued Citigroup for a preliminary injunction in June 2009 after Citigroup declared a default and refused to continue advancing funds under a $155 million construction loan. As more fully described in the prior article, the Appellate Division of the New York Supreme Court upheld the lower court's preliminary injunction requiring Citigroup to continue funding the loan.

The litigation on the merits remains pending, but, in the interim, two related suits have been filed. In November 2009, Carousel Center Company, L.P., and Carousel Enterprises Company, L.L.C., affiliates of Destiny and the borrowers under separate mortgage and mezzanine loans for the benefit of the mall, also filed an action against Citigroup in Onondaga County, New York. The affiliated Carousel companies allege that Citigroup wrongfully rejected requests for one-year extensions of the mortgage and mezzanine loans totaling $410 million and seek money damages and a declaratory judgment that the companies have met the cash flow requirements to extend the loans.

Simultaneously, Citigroup sued the Carousel companies in New York City, seeking declaratory judgment that the mortgage and mezzanine loans were due and payable in January 2010. Citigroup also sought to have the two most recent actions consolidated and litigated in New York City (being the venue selected by the parties in the mezzanine loan documents). Destiny and the Carousel companies, however, requested the consolidation of all three actions—the original Destiny litigation as well as the two more recent lawsuits—in Onondaga County. The state court in Onondaga County granted Destiny's and the Carousel companies' motions. Among the reasons given by the court were that the loans were interrelated components of a complex financing structure for one real estate development and that the court in Onondaga County was already familiar with the various actions, loan documents and issues in the cases.

Thus, we await any decision on the merits of these three lawsuits.

Fontainebleau Las Vegas LLC v. Bank of America

Fontainebleau Las Vegas LLC, the developer of a $2.9 billion casino resort in Las Vegas, sued Bank of America and other lenders in April 2009 in Clark County District Court in Las Vegas (later moved to the federal district court in Las Vegas) for denying the disbursement of a $656.5 million revolving loan to continue construction. As described in the prior article, several Fontainebleau entities then filed for bankruptcy. Fontainebleau subsequently withdrew its lawsuit in the Las Vegas court against Bank of America and refiled it in Miami bankruptcy court along with its bankruptcy petitions. The defendant lenders, however, were successful in moving the case out of bankruptcy court to the U.S. District Court for the Southern District of Florida. The District Court judge in Florida thereafter denied Fontainebleau's motion for partial summary

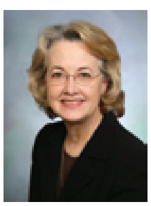
Lender Liability Case Law Update (continued)

judgment, indicating that the lenders were legally correct in their interpretation of what "fully drawn" meant in the credit agreement, and that, even if Fontainebleau's interpretation were correct, material issues of fact existed as to whether the lenders were relieved of their funding obligation on the basis of a borrower default. The interpretation dispute related to the credit agreement's requirement that the term loans be "fully drawn" before any disbursement could be made under the revolver; Fontainebleau argued that "fully drawn" meant "fully requested," whereas the lenders took the position that it meant "fully funded." Fontainebleau had requested the $656.5 million disbursement under the revolver at the same time it made a final draw request under one of the term loans. Fontainebleau requested an interlocutory appeal of both the order denying summary judgment and the order removing the case to district court, but in February 2010 both requests were denied. Mediation appears to have been unsuccessful thus far at resolving the dispute, so the litigation continues.

Other related lawsuits have been ongoing as well, including suits by term lenders against the revolver lenders, by term lenders against Fontainebleau and by lenders against loan guarantors. Most recently, in February 2010, Lehman Brothers sued two Fontainebleau loan guarantors in Lehman's New York bankruptcy case, seeking to enforce certain loan guaranties totaling approximately $300 million.

In the meantime, contractors and other mechanic's lien holders pushed for the right to take the project out of bankruptcy with a credit bid. Several lenders, in turn, sued the construction companies in December 2009, claiming that the liens filed were subordinate to the lenders' interests. The bankruptcy court ultimately rejected the contractors' credit bid. In February 2010, Carl Icahn, via Icahn Nevada Gaming Acquisition LLC, purchased the hotel and casino out of bankruptcy for about $150 million. The price is far short of the cost of the project's construction, which will take an estimated $1.5 billion to complete.

At this point, neither case provides useful precedent for lender liability case law, and it still remains to be seen what effect these and other cases will have on the lender liability landscape.



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Allowing Non-Parties to Invoke the Usury Doctrine to Defeat Foreclosure

by Thomas V. Loran III and Noa L. Clark

In the aftermath of the era of subprime mortgage lending and so-called "Mom and Pop" lenders trying to take advantage of wildly inflated California real estate values, we have seen recurrent issues arise with respect to junior lien foreclosures that have created significant problems of lien priority for mortgage lenders and their title insurers. In this recently bygone era, we have witnessed aggressive real estate financing schemes often involving multiple loans secured by the same realty, with junior liens often being "marketed" to consumers as fixed-term, interest-only obligations. Due to the highly unregulated arena of "Mom and Pop" real estate finance, these junior mortgages are often, sometimes even unwittingly, set at usurious rates that exceed the lawful maximum rate of interest.[1]

Questions of priority have tended to arise when the junior lienor claims priority as a result of some off-record transaction such as a forgery of a junior lien reconveyance, which, if proven, would render the reconveyance of the junior lien *void ab initio* under applicable California state law and give the junior lienor ostensible "priority" over a first priority mortgage recorded after the supposedly forged reconveyance.[2] The defenses that a first secured mortgagee would have to such foreclosure action brought by such a "junior" lienor would include the standard equitable defenses of subrogation[3] and subordination.[4] However, like the merits of the "junior" lienor's allegation that its signature was forged on the deed of reconveyance, proof of each of these equitable defenses is highly fact intensive and typically cannot be adjudicated in the absence of a full-blown evidentiary proceeding.

We recently have had experience with such a situation and adopted a different, more streamlined attack on behalf of a title insurer and its first priority secured lender against a foreclosure action brought by a "Mom and Pop" junior secured lienor who claimed that the reconveyance of the deed of trust securing his $40,000 loan was forged by the beneficiary. Aside from the standard equitable defenses, the defense of usury may be available in this context to prevent foreclosure by the junior lienor prior to the maturity of the underlying junior mortgage loan.

It is currently an unresolved question under California law whether the defense of usury is available to a non-party to the usurious transaction to defeat attempted foreclosure by such a "junior" lienor. Proof of this defense typically involves legal, rather than factual, issues and is thus more readily susceptible to pretrial resolution by motion. Moreover, the policy of California law appears strongly to support making this defense available under the circumstances. However, there is conflicting authority, and this article will discuss both lines of cases, in the context of the rules developed in other jurisdictions, to suggest that the better rule would be for California courts to recognize "defensive" use of the usury doctrine in California by non-parties to the usurious transaction in the context of foreclosure and real estate finance practice.

Availability of the Defense of Usury

Non-California Case Authorities

In some jurisdictions, the defense of usury is available to subsequent mortgagee defendants in foreclosure suits.[5] For example, in the cases of *Cole v. Bansemer* and *Runkle v. Smith*, where the original borrowers were insolvent and all parties claiming liens or encumbrances on the borrowers' assets were before the courts, the courts allowed the holders of the subsequent lien or encumbrance to set up a usury defense to diminish the claim of a prior lienor. These non-California decisions necessarily take into account whether, under the applicable state foreclosure statutes, non-parties to a usurious loan may nevertheless assert the defense of usury to a foreclosure. In particular, where, as in *Cole v. Bansemer*, for example, the state usury statute was silent on third-party enforcement rights, non-California decisions have questioned whether it is logical or just to conclude that the applicable usury statute was intended solely for the protection of the immediate borrower.

California Usury Law

The Basic Rule: Usurious, Interest-Only Mortgages Will Not Support a Prematurity Non-judicial Foreclosure

In California, it remains an open question whether the defense of usury is available to a junior mortgagee whose estate and security interest are threatened by a non-judicial foreclosure initiated by a senior lender holding a usurious promissory note. The standard rule under California law is that no interest may be charged or recovered by a lender on a usurious loan.[6] The Court of Appeal summarized the rule in the case of *Epstein v. Frank*, 125 Cal.App.3d 111 (1981), which involved an interest-only promissory note that called for no principal payments prior to maturity:

> The attempt to exact a usurious rate of interest renders the interest provisions of the note void. The usurious provisions, however, do not affect the right of the payee to recover the principal amount of the note when due. **The inclusion of a usurious interest provision, therefore, results, in effect, in a note payable at maturity without interest.**

Id. at 122-123 (emphasis added, internal citations omitted). Thus, under California law, the borrower under a usurious mortgage would have no obligation to make the usurious interest payments and, accordingly, would not be in default for failure to make a usurious monthly interest installment payment when due.[7] It therefore follows that in the case of an interest-only mortgage loan, a usurious rate of interest operates to prevent foreclosure prior to maturity of the principal obligation.

California Case and Statutory Authorities Support Extension of the Defense of Usury to Junior Lienors

There is no question that in the context of a usurious loan that the borrower itself has standing to assert the defense of usury. Likewise, there is no statute in California that prohibits a subsequent lienor or mortgagee from asserting the usury defense. Nevertheless, California authorities, as in many other jurisdictions,[8] have grappled with permitting third parties to assert this defense and at times have reached inconsistent results. However, as explained below, and as has been upheld in other jurisdictions, formal recognition of the defensive use of the usury doctrine by non-parties to the usurious loan transaction should be available to forestall a legally invalid foreclosure. This result is supported both by California's strong public policy and California Civil Code Section 2924c(a)(1), which allows a junior lienor to "step in the shoes" of the beneficiary to prevent foreclosure of an obligation secured by a senior lien that is in foreclosure.

The strong public policy against foreclosures resulting in a forfeiture of real property in the absence of a loan default has been recognized in leading California appellate decisions. As expressed in *Bisno v. Sax,* 175 Cal.App.2d 714, 723-724 (1959), and *Bank of America v. La Jolla Group II,* 129 Cal.App.4th 706, 711-712 (2005), California has a strong public policy that a foreclosure sale is invalid where no actual default exists under the promissory note that the deed of trust secured. As a corollary to this rule, California cases strongly support making the usury defense to foreclosure available to junior mortgagees.

Allowing Non-Parties to Invoke the Usury Doctrine to Defeat Foreclosure (continued)

In effect, to prohibit assertion by a junior lienor of a valid usury defense to defeat such an improper foreclosure action would "amount to an enforcement of a penalty or forfeiture, a thing which equity abhors." *Bisno*, 175 Cal.App.2d at 725.

This right is further supported by the California non-judicial foreclosure statute itself. One of the features of the statute is the principle that junior lienors and others threatened by foreclosure of a senior obligation have the right to cure any default by the mortgagor, thereby preventing foreclosure and protecting their own interests and estates in the real property security for the multiple mortgage obligations. This right is embodied in California Civil Code Section 2924c(a)(1), which expressly gives a beneficiary under a subordinate deed of trust the right to step into the shoes of the borrower and cure the default on its behalf at least five business days prior to the public auction.[9]

The strong public policies reflected in the relevant case law and foreclosure statutes support the conclusion that in the context of real estate finance, the defense of usury is not available merely to protect the mortgagor, but rather extends to other lienors who have an interest and/or estate in the same realty that secures a usurious mortgage loan.

The Principal Rationales Against the Application of the Usury Doctrine Typically Do Not Apply in What Are Purely Lien Priority Disputes

The California cases have identified two principal rationales for nonrecognition of the usury doctrine by parties not directly involved in the usurious transaction. These can best be described as the "better deal" principle and the "offensive use" prohibition against invocation of the usury doctrine. Neither of these rationales, however, typically applies in what otherwise would be purely a lien priority dispute involving an attempt to assert usury defensively to stave off foreclosure and forfeiture of the real property security for a mortgage loan.

The "Better Deal" Principle Prohibiting Use of the Usury Doctrine

The primary policy consideration supporting California authorities that do not permit third parties from asserting the defense of usury is to prevent recognition of claims for usury that would give such third parties a "better deal" than the one they made when acquiring their interest and estate as a secured party.[10] Based on this key policy consideration, California courts have held that a buyer who purchases property subject to a usurious note cannot then bring an action to recover the usurious interest paid.[11] It also has been held, based on similar reasoning, that the holder of a junior encumbrance who knowingly takes subject to the senior indebtedness, which it later pays off to stave off foreclosure, may not then assert a claim for usury against the senior lienholder whom it paid.[12]

The *ratio decisis* supporting these decisions is that the usurious mortgage was considered in fixing the purchase price to be paid, such that the usurious interest is factored in as part of the purchase price. In these contexts, a claim for usury would give the claimant a better deal than the one it made.

However, at least in the case of a first secured mortgagee asserting the defense of usury to prevent foreclosure by an off-record lienor, it would be quite unusual for these policy considerations militating against use of the usury doctrine ever to come into play. In particular, a first secured mortgagee would not have knowingly bargained for a junior lien position with reference to an off-record lien and would not, moreover, be asserting the defense of usury to obtain a better deal than the one it made. Rather, the first secured mortgagee would be asserting the defense of usury to stave off foreclosure for protection of the real property that secures the debtor's loan.

The Prohibition Against "Offensive" Use of the Usury Doctrine

Another policy rationale underlying the reasoning of authorities that prohibit third parties from asserting claims of usury is the misuse of the usury doctrine as a sword by claimants who were not original parties to the transaction, such as where the third parties assert a usury claim and seek affirmative money damages in connection with the usurious transaction to which they were not original parties.[13] The use of the usury doctrine as a "shield"—rather than a sword—has been held to be the "real purpose"[14] for the enactment of the constitutional provision and the usury law.[15] In the hypothetical case of a first secured mortgagee asserting the defense against an off-record lienor claiming priority, the usury doctrine would be advanced not as sword, but only as a shield to prevent the off-record lienholder from relying on a foreclosure in the absence of a default by the borrower. Based on this rationale, California courts have permitted a junior lienholder to assert the usury doctrine defensively or to question the validity of the senior lienholder's prior lien.[16]

In addition, under California law, it is simply not the case that **only** the original borrower may assert claims of usury. While it has not yet expressly been held in California that a first secured mortgagee may assert the defense of usury, under California precedents a third party may assert claims of usury when it stands in the shoes of the original borrower and stands to be injured by the usurious transaction.[17] In the case of the first secured mortgagee, it would stand in the shoes of the borrower pursuant to Civil Code Section 2924c(a)(1), which, as mentioned above, expressly gives a beneficiary under a subordinate deed of trust the right to step into the shoes of the borrower and cure the default on its behalf.

Considerations Cited by California Courts to Deny Recognition of the Usury Defense Typically Do Not Apply in Lien Priority Disputes and Defenses to Non-judicial Foreclosure

Typically, none of the above disparate rationales prohibiting persons other than the borrower from asserting usury claims are applicable in the case of a first secured mortgagee asserting usury defensively to stave off foreclosure by an off-record lienor claiming lien priority: the first secured mortgagee would not have knowingly bargained for a junior lien position with reference to the off-record lien securing the usurious note; would not be asserting the defense of usury to obtain a better deal than the one it made; would not be using the usury doctrine as sword, but only as a shield to prevent the junior lienholder form relying on a foreclosure in the absence of a default by the borrower; and would stand in the shoes of the borrower pursuant to Civil Code Section 2924c(a)(1).

Moreover, the disparate policy rationales cited by the California courts in other contexts to deny recognition of the usury doctrine appear to be outweighed by the strong policy of the law expressed in the California cases and statutory foreclosure scheme: that a foreclosure sale is invalid where no actual default exists under the promissory note and a person adversely affected may obtain relief in court to overturn the sale, and a beneficiary of a subordinate deed of trust may step into the shoes of the borrower pursuant to Civil Code Section 2924c(a)(1).

Conclusion

In light of the above rationales and policies that support making the usury defense available to a first priority secured lender to defeat foreclosure actions by a junior lienor in certain circumstances, it seems reasonable that California courts will formally adopt the rule as recognized in other jurisdictions, especially as more and more of these questions of priority make their way through the judicial system.

Allowing Non-Parties to Invoke the Usury Doctrine to Defeat Foreclosure (continued)

Endnotes

1 Under Paragraph 2 of Section 1 of Article 15 of the California Constitution, the maximum lawful interest rate chargeable on a loan in California is the higher of (a) 10% per annum simple interest or (b) 5% per annum, plus the rate prevailing—as established by the Federal Reserve Bank of San Francisco on advances to member banks under Sections 13 and 13a of the Federal Reserve Act—on the earlier of the date of execution of the loan papers or the date of loan funding. Since February 2005, the maximum allowable interest rate generally has been 10%, has never been higher than 11.25% (during brief periods) and currently is at 10%.

2 *See Wutzke v. Bill Reid Painting Services, Inc.,* 151 Cal.App.3d 36, 40-42 (1984); *accord*, *Clyne v. Brock,* 82 Cal.App.2d 958, 963 (1947); 4 Miller & Starr, California Real Estate (3d. Ed. 2000) Deeds of Trust and Mortgages, §10:116, p. 356 (stating that "[a] reconveyance that has been obtained fraudulently or by forgery can be set aside by a court of equity").

3 Equitable subrogation is authorized under California Civil Code §2903:

> Every person, having an interest in property subject to a lien, has the right to redeem it from the lien, at any time after the claim is due, and before his right of redemption is foreclosed, and, by such redemption, becomes subrogate to all the benefits of the lien, as against all owners of other interests in the property, except in so far as he was bound to make such redemption for their benefit.

See also *Stein v. Simpson,* 37 Cal.2d 79, 83-84 (1951) (discussing California Civ. Code §2903).

4 *See, e.g., Del Conte Masonry Co. v. Lewis,* 16 Cal.App.3d 678 (1971) (applying equitable subordination doctrine in dispute concerning equitable lien claim preference).

5 *E.g., Vassar Holding Co. v. Dunlap et al.*, 143 A.2d 67 (N.J. 1928); *Cole v. Bansemer*, 26 Ind. 94 (Ind. 1866); *Runkle v. Smith,* 89 N.J. Eq. 103 (1918).

6 *E.g., Haines v. Commercial Mortgage Co.,* 200 Cal. 609, 617 (1927); *accord*, *Moore v. Russell*, 114 Cal. App. 634, 641-642 (1931).

7 It is important to note that while estoppel is a hypothetical defense to usury, under California law an estoppel to assert usury typically does not arise unless there is evidence of fraud. *See Martin v. Ajax Construction Company,* 124 Cal.App.2d at 431 (stating that "[i]n order to bar the defense of usury, the illegal provision in the instruments must have been knowingly and fraudulently inserted"). But cf. *Lakeview Meadows Ranch v. Bintliff,* 36 Cal.App.3d 418, 424 (1973) (holding that estoppel defense was applicable where evidence showed that plaintiff's lawyer, acting in its capacity as plaintiff's agent, had drafted usurious instrument and intentionally inserted the usurious terms therein). Moreover, under California authorities, even when a borrower has full knowledge of the usurious nature of the transaction, and complies with the terms of the usurious loan, the borrower will not be estopped from asserting a claim of usury. *See e.g.*, *Stock v. Meek,* 35 Cal.2d at 817 (1950); *accord*, *Williams v. Reed,* 48 Cal.2d 57, 68 (1957); *Martyn v. Leslie,* 137 Cal.App.2d 41, 58 (1955) (stating "no borrower is estopped from asserting usury merely because he has knowingly met the usurious exactions of the lender").

8 *Compare*, *e.g.*, *Vassar Holding Co. v. Dunlap et al.*, 143 A.2d 67 (N.J. 1928) and *Allee v. Benser,* 779 S.W.2d 61 (Tex. 1988) (approving defensive assertion of usury) with, *e.g.*, *First State Bank of St. Edward v. Niklasson et al.,* 218 N.W. 744 (Neb. 1928) and *Levitch v. Schaengold et al.*, 181 N.E. 821 (Ohio Ct. App. 1931) (disapproving). *See generally* 47 C.J.S. (2001) Interest & Usury, §247 (discussing rights of a subsequent mortgagee asserting defense of usury).

9 California Civil Code Section 2924c(a)(1) permits "any beneficiary under a subordinate deed of trust or any other person having a subordinate lien or encumbrance of record thereon" to cure the default of the original borrower if the power of sale is exercised.

10 *Roes v. Wong,* 69 Cal.App.4th at 378-79 (1999) (reasoning that where property is purchased subject to a usurious loan, the law presumes that the usurious interest was factored in as part of the purchase price, and stating that "[i]n this context recognizing a claim for usury would give the purchaser a better deal than the one he made").

11 *E.g.*, *Mathews v. Ormerd,* 140 Cal. 578, 582 (1903); *accord*, *Espositi v. Rivers Brothers, Inc.,* 207 Cal. 570, 572-573 (1929); *Read v. Mortgage Guarantee Co.,* 11 Cal.App.2d 137, 142-134 (1936).

12 *E.g.*, *Barnes v. Harman,* 246 Cal.App.2d 215, 223 (1966) (observing that "by satisfying the demands of the holder of the senior encumbrance, even though the senior loan is usurious in nature, the holder of the junior encumbrance does not have a cause of action"); *accord*, *Roes,* 69 Cal.App.4th at 378-379. *See also In Re Dominelli,* 820 F.2d 313, 318 (9th Cir. 1987) (observing in dicta that there is no indication that a "junior lienholder, particularly one who made a loan **with notice** of the senior lienholder's usurious loan, is entitled to assert the defense of usury") (emphasis added).

13 *See* California Civ. Code §1916-3(a) (authorizing treble damages for recovery of interest paid in usurious loan transaction). Claimants asserting usury in *Roes*, *supra*, and *Barnes*, *supra*, and in *Domarad v. Fisher & Burke*, Inc., 270 Cal.App.2d 543 (1969), all sought affirmative money damages in connection with usurious transactions to which they were not original parties.

14 *E.g.*, *Barnes v. Harman,* 246 Cal.App.2d at 224 (stating that "[u]nder the facts of this case the claim of usury is not being used as a shield which was the **real purpose** in the enactment of the constitutional provision and the Usury Law") (emphasis added).

15 *See* footnote 1, *supra*.

Allowing Non-Parties to Invoke the Usury Doctrine to Defeat Foreclosure (continued)

[16] *E.g.*, *Roesch v. De Moto,* 24 Cal.2d 563, 574 (1944) (allowing a junior lienholder to enjoin foreclosure on the basis of a usurious senior loan); *Garms v. Jensen,* 103 Cal.374, 377 (1894) (allowing a junior lienholder to question the validity of a senior lien on the basis that it contravened a penalty provision of the constitution prior to the adoption of California's Usury Law).

[17] *E.g.*, *Sosin v. Richardson,* 210 Cal.App.2d 258, 614 (1962) (observing that "where a promissory note is given for usurious loan, vice of usury may be asserted by guarantor of the note as well as by maker"); *Martin v. Ajax Construction Co.*, 124 Cal.App.2d 425,431 (1954) (determining that guarantor under a usurious loan transaction can assert the claim of usury); *North v. Cecil B. De Mille Productions, Inc.,* 2 Cal.2d 55, 59 (1934) (determining that receivers of corporation *pendente lite* could be joined with corporation in action to recover usurious interest paid by corporation, since both receivers and corporation had interest in subject-matter of action). *See also Nuckolls v. Bank of California, National Ass'n,* 10 Cal.2d 278 (1937) (reasoning, albeit in dicta, that an assignee or trustee in bankruptcy could assert defense of usury).

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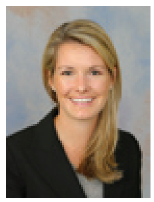

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