

Real Estate Bulletin

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Credit Enhancement by Glenn A. Fuller Esq.

Why Credit Enhancement?

While lenders will make real property secured lending decisions based on an analysis of the real estate assets intended to secure the loan in question, many lending decisions will be predicated on a set of assumptions regarding the continued and anticipated future operations of the property, the financial strength of the principals of the borrowing entity and a host of other factors.

California law imposes strict limitations, both from a procedural and remedies standpoint, on lenders' ability to collect on their security following a real estate secured loan default. These rules, intended to protect borrowers from the immense potential for abuse of the "non-judicial" foreclosure process, are often collectively referred to as "Anti-Deficiency Rules." Coupled with precise and unforgiving procedural requirements, these rules can seriously hamper a lender in the event an asset is impaired and, if not adhered to, can cause a foreclosing lender to lose its security altogether.

As such, lenders will often seek alternate methods to protect themselves both before and after a default without violating the Anti-Deficiency Rules. These various devices are referred to in general as "credit enhancement." Credit enhancement tools vary greatly and have evolved both through usage and case law as accepted exceptions to the Anti-Deficiency Rules. Lenders will seek credit enhancement so they can make loans on more favorable terms (or even make loans they otherwise

would not make) because the lender has an alternate source of repayment and/or a method to ensure that the asset securing the loan is well maintained. In general, it is imperative that real estate professionals have a solid grasp of the variety and application of credit enhancement devices to know how to close the gap between lenders and borrowers and to ascertain how to reduce lenders' risks while being able to understand and advise borrowers of the costs, risks and benefits of various credit enhancement devices.

The California Anti-Deficiency Laws: A Quick Primer

California statutory and case law provides that in order for a secured lender to obtain a deficiency judgment against a debtor, certain specific steps must be taken. California courts have consistently maintained that the anti deficiency laws represent strong public policy interest, and, as such, cannot be waived. A foreclosure action in California can only be undertaken in one of two ways: by a non-judicial foreclosure (sometimes called a "trustee's sale") or by a judicial foreclosure. For reasons that are beyond the scope of this article, the overwhelming number of foreclosures in California are nonjudicial foreclosures in which the beneficiary compels the trustee to conduct a foreclosure sale pursuant to the private power of sale provisions in a deed of trust. This method of foreclosure is private action wherein the public can bid for the purchase of the property and the high bidder is awarded title to the property at the sale. The difference, if any, between the amount of the winning

bid and the outstanding amount secured by the deed of trust is referred to as a "deficiency."

By electing to pursue the quick and simple non-judicial foreclosure sale, the foreclosing lender will waive its right to pursue the borrower for any deficiency. As such, absent some other form of security, the value of the asset is a lender's only source of repayment.

For reference, the most significant of these statutes dealing with the Anti-Deficiency Rules are:

> **Code of Civil Procedure § 726(a)** requires that a lender proceed first against the real property security before seeking a personal judgment. A failure to proceed against the real property security before obtaining a personal judgment against the debtor or proceeding against unencumbered assets may result in a lender's loss of the security interest.

> **Code of Civil Procedure § 726(b)** limits any deficiency judgment in a judicial foreclosure against a borrower to the lesser of the difference between the mortgage debt and the foreclosure sale price or the difference between the mortgage debt and the fair value of the property at the time of the foreclosure sale.

> **Code of Civil Procedure § 729.010 et seq.** grants the foreclosed property owner a one (1) year post-foreclosure right of redemption of real property sold at a judicial foreclosure. This redemption right, when combined with the valuation restrictions of Code of

Civil Procedure § 726(b), is intended as an inducement to prevent foreclosing lenders from deliberately underbidding at a judicial foreclosure sale because the lender could forfeit the difference between its successful credit bid and the judicially determined fair value of the property.

> **Code of Civil Procedure § 580 (d)** prohibits a deficiency judgment following a non-judicial foreclosure.

> **Code of Civil Procedure § 580 (a)** limits a deficiency judgment following a non-judicial foreclosure to the lesser of the difference between the mortgage debt and the foreclosure sale price or the difference between the mortgage debt and the fair value of the property at the time of sale. Since § 580(d) absolutely prohibits deficiency judgments following a non-judicial foreclosure, § 580(a) would seem to have no practical purpose; however, § 580(a) is often employed in unusual situations, such as attempts by junior lienholders to obtain personal judgments against the mortgagor after acquiring the property at the senior lienholder's non-judicial foreclosure.

> **Code of Civil Procedure § 580(b)** prohibits deficiency judgments following any foreclosure (judicial or nonjudicial) of a mortgage or deed of trust securing purchase money debt. This statute may seem irrelevant to mortgage lending because the statute only applies to vendors who take back purchase money debt and lenders who lend to borrowers for the purpose of acquiring owneroccupied residential property. However, there is a line of cases which has expanded the definition of "vendor" to mortgagees who were not, in fact, vendors of the property. For example, in *LaForgia v. Kolsky*, 196 Cal. App.3d 1103, 242 Cal.Rptr. 282 (1987), a lender who made a non purchase money loan was held to be a "vendor" within the meaning of § 580(b), because he renegotiated his loan in connection with a bankruptcy sale of the property. According to the Court of Appeal, the lender "became the equivalent of a vendor by executing new and different financing documents with the new purchaser."

Guarantees

Guaranties.

Guarantees are a preferred form of credit enhancement because the added transaction costs are relatively low and the use and enforceability of guaranties are well established under California case law and statute. In order to circumvent the Anti-Deficiency Rules, lenders desiring to obtain guaranties will require that the borrower in a commercial real estate loan be a single asset entity and the guarantors (who are usually affiliated with the borrower) execute guarantees on behalf of the borrower.

Types of Guaranties.

Depending upon the relative bargaining strength of the parties, many guaranties are limited in some respect. The most common types of such restrictions are:

> *Partial Guaranties.* Sometimes a guaranty will unconditionally guarantee payment of the principal debt at the inception of the loan, but provide that the guarantor's liability is limited to a specified dollar amount throughout the course of the loan (sometimes called a "burn rate"). These guaranties can be "first dollar" guaranties or "last dollar" guaranties (or a blend of the two). Under a "first dollar" guaranty, the guarantor's maximum dollar liability is reduced as the loan is paid down. Since under "first dollar" guaranties the guarantor's risk is limited to the early stages of the loan, lenders naturally resist such arrangements. Under a "last dollar" guaranty, the guarantor's maximum exposure continues until the entire debt has been reduced to a certain threshold and then reduces as the loan is paid off after the appropriate dollar amount has been achieved. Thus, the "last dollar" guaranty is much more valuable to a lender.

> *Completion Guaranties.* It is common practice in connection with construction loans for a lender to require a party to execute a "completion guaranty." These guaranties are designed to alleviate one of a lender's biggest fears when making a construction loan: that the project will not be finished and the construction lender will be forced to foreclose on an incomplete

construction project. The difficulty with this type of guaranty, however, is that the obligations of the guarantor are not entirely clear and there is little in the way of substantial case law on these guaranties. If the guarantor does not complete the project, lenders will presumably contend that the measure of their recovery should be the cost of completing the improvements; however, at least one court who addressed this issue has held that the lender's "recovery is limited to the injury to the mortgagee's security interest which is measured by the difference between the value of the property with and without the completed improvements." *Glendale Fed. Sav. & Loan Assn. v. Marina View Heights Dev. Co.*, 66 Cal.App.3d 101, 124 125, 135 Cal.Rptr. 802 (1977).

> *Carve Out Guaranties.* Since the possibility of a judicial foreclosure is present in California (in which a lender can recover a deficiency judgment), many borrowers still insist that their loan documents provide that, in the event of default, the lender can proceed only against the encumbered property, and not against the debtor personally. Lenders commonly insist on express exceptions to this general rule, generally referred to in the lending industry as "carve outs." These carve outs typically include such items as fraud, waste, misapplication of rents and insurance proceeds, and the like. Lenders frequently require a guarantor to guarantee payment of these carveouts. The purpose of this guaranty is more to control conduct than to collect money under the theory that a borrower is less likely to commit these bad acts if a controlling person of the borrower has the specter of personal liability for such actions.

Springing Guaranties.

A "springing guaranty" is a guaranty which only becomes effective upon the occurrence of a particular event. A typical springing guaranty will be a guaranty that will only become effective upon a borrower's bankruptcy filing. Like the carve-out guaranty, this type of guaranty is really intended more to force the guarantor to control its affiliates' conduct than anything else. For instance, to use the borrower's bankruptcy filing as an example, the purpose of a springing guaranty effective

only upon the borrower's bankruptcy is to give the borrower's controlling persons a strong incentive to allow the lender to foreclose following a default, rather than to cause the borrower to file for bankruptcy to avoid a foreclosure; however, this type of guaranty can create a severe conflict of interest for the guarantors if there are non guarantor minority owners of the borrower. In some cases, the interests of the borrower entity may be best served by filing for bankruptcy, but the controlling guarantor or guarantors will have a strong personal incentive to allow the lender to foreclose.

Guarantors' Rights: Waiver.

California statutes and case law provide guarantors with a myriad of defenses and limitations to guaranties, however, California Civil Code §2856(a)(3) provides that all of the defenses and limitations imposed by statute and case authority can be waived except for the overriding principal that a guarantor cannot guaranty its own debt. As such, almost all attorney drafted guaranties contain broad waivers of these rights. Specifically, at a minimum, most well drafted guaranties will specifically cite and have the guarantor waive the following:

> The obligation of a guarantor may be neither larger in amount nor in other respects more burdensome than that of the principal. (Cal.Civ.Code § 2809.)

> A guarantor is exonerated if by any act of the creditor the original obligation of the principal is altered in any respect, or the remedies or rights of the creditor against the principal are impaired. (Cal.Civ.Code § 2819.)

> A guarantor may require the creditor to proceed against the principal or to pursue any other remedy in the creditor's power which the guarantor can not pursue and which would lighten the guarantor's burden. (Cal.Civ.Code § 2845.)

> A guarantor who satisfies the principal obligation, or any part thereof, is entitled to reimbursement from the principal. (Cal. Civ.Code § 2847.)

> A guarantor, upon satisfying the obligation of the principal, is entitled to

be subrogated to the rights which the creditor then has against the principal to the extent of reimbursing what the guarantor has expended, and also to require all co guarantors to contribute thereto. (Cal.Civ. Code §§ 2848 & 2849.)

> Whenever property of a guarantor is hypothecated with property of the principal, the guarantor is entitled to have the principal's property first applied to satisfaction of the debt. (Cal.Civ.Code § 2850.)

> If a lender nonjudicially forecloses upon real property security for the debt (and thereby loses the right to a deficiency judgment under the California anti deficiency laws), the lender is estopped from proceeding against the guarantor because the lender has destroyed the guarantor's rights of subrogation and reimbursement. Usually called the "Gradsky Defense" named for the case that recognized this limitation. *Union Bank v. Gradsky*, 265 Cal.App.2d 40, 71 Cal.Rptr. 64 (1968).

"Sham Guaranties".

The California courts have consistently held that a borrower cannot guarantee its own loan. As such, if a guarantor is liable in any way under the principal loan (even as a general partner), the guaranty will not be valid.

The consequences of treating a principal obligor as a guarantor can be disastrous if the lender actually attempts to enforce the guaranty before proceeding against the property. If a judicial determination is made that the guarantor and the borrower are really the same, moving to enforce or attach any of the guarantor's assets will violate the "one form of action rule" and "security first" requirement of Code of Civil Procedure § 726 and will result in a forfeiture of the lien on the real property.

How to Enforce a Guaranty

In the vast majority of circumstances, lenders will nonjudicially foreclose against the security for the debt and thereafter proceed against the guarantor. Then, at least, the lender will have the property (the principal source of repayment) and can

proceed against the guarantor later, which is likely to be a more drawn out affair if the lender is forced to sue. This scenario does, however, give the guarantor the opportunity to raise a number of defenses that would otherwise be unavailable, including the fairness and validity of the sale, the "sham guarantor" defense, and the like.

Letters of Credit

Letters of Credit.

Without a doubt, a letter of credit is the best form of credit enhancement since the letter of credit provides a fast and reliable means of collection. Nonetheless, letters of credit are not common in mortgage financing because they involve up front costs and require that the borrower have a separate basis for credit in addition to the mortgaged property. A letter of credit is "a definite undertaking . . . by an issuer to a beneficiary at the request or for the account of an applicant . . . to honor a documentary presentation by payment . . ." (Cal. U.C.C. §5102 (a)(10).) In simpler English, a letter of credit is a promise by a financial institution (usually a bank) given to a third party to pay money to that party upon the presentation of specified documents specified in the letter of credit. A letter of credit transaction always involves at least three parties and three sets of relationships. The parties are: (1) the issuer of the letter of credit; (2) the issuer's customer, at whose request the letter of credit is issued (in this case, the borrower); and (3) the beneficiary of the letter of credit (in this case, the lender). Although from a factual standpoint all three relationships are related, the law governing letters of credit provides that, for the most part, these relationships are independent.

The relationships work as follows: (i) The letter of credit itself creates the relationship between the financial institution that issued the letter, who has the obligation to pay, and the party to whom the letter of credit is issued, who has the right to draw down the letter of credit; (ii) the party who causes the letter of credit to be issued delivers the letter of credit to the party entitled to draw off the letter of credit pursuant to an independent contractual agreement between these parties; (iii) the financial institution issuing the letter of credit, who has the obligation

to pay under the letter of credit, will have an independent relationship with its customer dictating the terms of the issuance of the letter (usually this agreement is called a "Reimbursement Agreement"). Typically, this arrangement will involve the issuance of some sort of collateral to the financial institution issuing the letter of credit.

The independence of these relationships is one of the major benefits of the letter of credit to lenders – except for the explicit requirements set forth on the letter of credit itself, the financial institution advancing the letter of credit must honor the draw request of the lender upon presentment.

A letter of credit typically serves a gap filling function by which they support either a portion of a loan and/or they expire on the occurrence of certain events (such as completion of certain improvements, a leasing threshold reached or the borrower's maintenance of certain cash flow or debt service or other ratios for a prescribed period of time). If the borrower (or its principal) has other assets and good credit, it can transfer that creditworthiness to the particular mortgage loan by having a financial institution issue a letter of credit to support the mortgage loan. Since letters of credit are regarded as only one step below cash, the letter of credit will support a larger loan than the lender would otherwise be willing to give.

The problem with letters of credit in lending transactions, however, is that they tend to be very expensive and require the borrower to have a large credit capacity.

The Issuer's Responsibility: Preclusion.

The responsibilities of the issuer upon receiving a demand for payment are equally mechanical and strict. The issuer has a "reasonable time after presentation, but not beyond the end of the seventh business day" to either honor the payment demand or give notice to the presenter of any discrepancies. (Cal.U.C.C. §5108 (b); UCP Article 14(d); ISP Rule 5.01 a.) If notice of dishonor is not given within this period, the issuer is precluded from asserting the existence of any discrepancies in the documents, i.e., it must honor the request for payment. (Cal.U.C.C. §5108(c); UCP

Article 14(e); ISP Rule 5.03.) If the notice of dishonor is given, it must "state all discrepancies in respect of which the bank refuses the documents..." (UCP Article 14(d)(ii). See also ISP Rule 5.02.) (Notice of dishonor "shall state all discrepancies upon which dishonour is based."). A general reference to discrepancies is inadequate; the notice of dishonor "must make a specific reference to the document in question." *Toyota Tsusho Corp. v. Comerica Bank*, 929 F.Supp. 1065, 1075 (E.D. Mich. 1996). In essence, the notice of dishonor must give the beneficiary a "road map" of what it must do to correct the deficiencies and make a second presentment for payment. This notice of dishonor is critical, because any discrepancies not identified by the issuer are waived and may not thereafter be relied upon as a defense to payment. (Cal. U.C.C. §5108(c); UCP Article 14(e); ISP Rule 5.03.) This waiver is binding even if the discrepancies not identified are incurable, and could not have been corrected by the beneficiary. *Kerr McGee Chemical Corp. v. FDIC*, 872 F.2d 971 (11th Cir. 1989); *Toyota Tsusho Corp.*, supra, 929 F.Supp. at 1073 1074.

Issues of Concern Regarding Letters of Credit.

While letters of credit have immense advantages, there are some quirks regarding these letters that must be taken into consideration. The first is that a letter of credit must have a fixed expiration date. (UCP Article 42(a).) In addition, it is customary for a letter of credit to expire no later than one year after it is issued. Obviously, this time period is too short for most lending transactions. To mitigate against this problem, some issuers will provide that although the letter of credit will expire at a certain time, it will automatically be renewed unless the issuer provides the lender with notice (these are typically called "Evergreen Clauses"). A typical Evergreen Clause will provide, however, that the decision not to renew the letter can be made at the issuer's discretion. This can put the lender in the acquired position of having to draw on the letter even though the borrower is not in default or lose its collateral.

Another quirk regarding letters of credit is that they are issued in favor of a specified

beneficiary. Unless a letter of credit is specifically identified as "transferable," the beneficiary's rights may not be transferred at all. (Cal.U.C.C. §5112 (a).) Even a letter of credit designated as "transferable" may only be transferred "to the extent and in the manner expressly consented to by the bank." (UCP Article 48(c).) As a practical matter, this means that a letter of credit is of limited usefulness with respect to a loan that is made with a view to sale or assignment unless the original lender will remain as lender of record following the assignment.

Interest Protection Devices; Swaps, Caps and Collars

Many transactions, including securitized loans, are done with floating rates interest based on an independent index. Since the interest rate charged will move during the term of the loan, a lender's initial underlying assumptions may change so drastically that the deal does not make sense. To mitigate against this risk, banks and other institutions involved in real estate finance have developed certain arrangements to deal with this risk.

Interest rate swaps are agreements between lenders wherein a bank with fixed rate debt and a party with floating debt agree to make each other's interest payments. The agreement may be directly between the parties or, more typically, is brokered by a financial institution that is paid a fee and services the arrangement. It is important to note that these two parties (called "counterparties") do not assume each other's debt, only the interest payments obligation.

Interest caps and collars are direct arrangements between borrowers and financial institutions where, for a fee, the financial institution agrees to pay all interest above a certain rate (in the case of a cap) or all interest above a certain rate, but receiving interest if rates fall below a floor (in the case of a collar). The pricing is expensive for this necessary device in most securitized transactions.

The Effect of Rating Agencies on Debt Instruments

What is Securitized Debt?

Increasingly loans are being pooled into securities and sold on Wall Street as debt instruments. Such arrangements are generally referred to as "securitization." The pricing and ability to sell these securities is predicated almost exclusively on the rating given (which reflects the quality of the instrument).

The practical effect that this has is to try to standardize all of the loans in the pool, and this will include the type and quality of credit enhancement. The value of the indirect credit enhancement derives from the bond rating agencies review of all aspects of the investment. In order to receive an investment grade rating, many aspects of a real estate transaction will be examined including, without limitation, the credit-worthiness of tenants, cash flow and other factors that ensure the quality of the underlying collateral. As such, credit agencies will typically demand alternate forms of credit enhancement for all real estate assets in the portfolio to ensure that all of the collateral is maintained and insured. Typically, these goals are achieved by using Impound Accounts and Reserve Accounts and standardizing insurance coverage.

Impound Accounts.

Impound accounts are accounts established by lenders that require borrowers to deposit sums of money, usually a fixed amount on regular intervals, earmarked for a specific purpose. The most common uses for impound accounts are for real property taxes and insurance premiums. In the typical scenario, every month during the term of the loan, the borrower will deposit one-twelfth (1/12) of the anticipated amount of the anticipated yearly costs for such expenditures into the designated account maintained by the lender. When the appropriate bill for the cost is tendered to the lender, the lender will pay such amounts directly to the taxing authority or insurance company.

Reserve Accounts.

Similar to impound accounts, reserve accounts are intended as a method for lenders to be able to ensure that the collateral is maintained to lessen the lender's exposure in the event of a foreclosure.

Reserve accounts are established for capital replacements, regular maintenance and other costs that are expected to be insured in the operation of a real estate asset. Maintaining a reserve account generally involves the borrower being required to deposit certain set sums into earmarked accounts. The amount of such funds is usually determined on a per square foot basis and the funds are reserved to pay for certain sums expended to maintain or improve the real estate asset. The purpose of these accounts is to ensure that the borrower maintains the asset and otherwise does not defer maintenance or capital expenditures which, in turn, ensures that the lender's collateral is maintained property and keep its value.

Although maintenance of reserve accounts is, in theory, something that should not create an increased burden on borrowers, since the funds set aside are meant to maintain or improve an asset owned by the borrower, the amount, description of the expenses and method of obtaining use of the reserved funds can be a significant burden for a borrower if not drafted properly and generally require careful scrutiny to ensure that the funds are available to be used by a borrower when needed with as little administrative problems as possible.

Lock Box Arrangements.

A "lock box" is a mechanism wherein the income from the property is placed in an account maintained by the lender, who then pays the debt service payments and impound or other reserve accounts directly. While this is a powerful credit enhancement tool for lenders, such arrangements obviously seriously impair borrowers' operations and can be impractical for businesses with cash flow or other special considerations.

Insurance Clauses.

> "Loss Payee" Clauses. Many insurance policies simply reflect the fact that the lender is a "loss payee" under an appropriate insurance policy. This type of coverage is often inadequate since it simply provides lenders the rights of the primary policyholder. As such, the insurer will have a defense against the lender if the borrower failed to comply with policy provisions.

> "Mortgage Endorsements". In contrast to a "Loss Payee" endorsement, a "Mortgagee Clause" (also called a "Lender's Loss Payable Endorsement") can protect the lender's interest even if the borrower fails to comply with all policy provisions. As a note, these endorsements often do not automatically provide lenders with the right to seek coverage under all aspects of the borrower's policy unless specifically stated (for instance, it is good practice for lenders to specifically state that the endorsement covers business interruption, earthquake and other types of expanded coverage), and the "Lender's Loss Payable Endorsement" may only apply to insurance in place when the endorsement is issued and not necessarily for after acquired insurance. As such, if insurance coverage is materially modified, supplemented or replaced, it is imperative that lenders ensure that these endorsements still provide adequate coverage.

> "Insurable Interest". In order to recover under a loss payable or other type of endorsement, the lender must have an "Insurable Interest" in the property insurance. In order to establish an "Insurable Interest," the property subject to the loss must be part of the lender's collateral for the loan. As such, it is extremely important for lenders to specifically list all real estate and non-real estate collateral used to secure their loans.



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