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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/Preface

Preface

This book was initially published in 1988 as California Real Property Financing 1. Like its predecessor, this book is transaction oriented. This edition focuses on negotiating and drafting the basic forms commonly used in real estate commercial loan transactions. Written by highly respected experts in real estate finance, it begins by describing the current sources of financing, including Wall Street's involvement through conduit financing, and goes on to provide negotiating and drafting strategies for the primary loan documents. New in this edition is a comprehensive chapter on legal opinions, which analyzes the anatomy of a legal opinion and sets forth a form based on the ABA-ACREL form.

Real estate financing is an area of law that affects not only real estate practitioners but many other lawyers who are asked to advise clients who occasionally make or obtain real property secured loans. Issues abound that can create traps for the unwary from prepayment charges to usury to cross-defaults. Borrowers' counsel know that some lender requirements are negotiable while others can seldom be modified. Knowing the difference can save the client both time and money. The authors of this book have endeavored to explain what a lender needs and why—and what a borrower can realistically negotiate. The forms, which can be taken together to create an integrated loan document package, not only provide basic terms but many options and alternatives to help tailor them to specific circumstances.

This book is a companion to California Mortgage and Deed of Trust Practice (3d ed Cal CEB 2000); together they form CEB's new Real Property Secured Transactions Series. Although this book focuses on negotiating and drafting the transaction, Mortgage & Deed of Trust Practice is a practical guide to enforcing real property security devices and also deals with loans that are in trouble, covering workouts, bankruptcy, and lender liability.

The practical expertise of the authors of this book is one of its greatest assets. Their in-depth knowledge of the law and their vast practical experience and understanding makes this book essential to any attorney faced with negotiating, drafting, or reviewing loan documents. During a time when most real estate lawyers are busier than ever, these lawyers gave generously of their time and expertise, for which CEB is extremely grateful. Their names appear in the About the Authors section of this book.

All chapters of this book were reviewed by practicing lawyers throughout the state. CEB extends a special thanks to those consultants, who are listed on the Acknowledgments page.

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The project manager for this book was Janis LaRoche Blanchette. CEB attorneys Donald R. Briggs and Bonnie C. Maly, together with Janis LaRoche Blanchette and Ann Davis, Esq., were the legal editors. CEB senior editor Cinda Ely handled copyediting and production. Legal research was performed by Maria Borje-Bonkowski, Clinton Hein, Alice Kostin, Kenneth Marr, Thomas Quinn, Shawn Ridgell, Frederike Schilter, Carolyn Valley, and Martin Weis. Jenny Jones wrote the index. Grier Thornburg designed the cover. Composition was performed by CEB's Electronic Publishing staff.

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For more on the 2009 update authors, see the About the 2009 Update Authors section of this book.

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Selected Developments

October 2009 Update

A bankruptcy court refused to allow the holder (and servicer) of a note to proceed with its foreclosure action without joining the "owners" of the note. See *In re Kang Jin Hwang* (Bankr CD Cal 2007) 396 BR 757, discussed in §1.42.

The 2009 bankruptcy filing by General Growth Properties, owner of more than 200 shopping malls and the single largest commercial mortgage-backed securities (CMBS) borrower in the United States, involves 166 separate, single-purpose, supposedly bankruptcy-remote entities. See §§1.92, 1.96, 10.13, 10.15A, 10.16.

Rate lock agreements have come under increasing judicial scrutiny. See *Wisconn Invs., LLC v Wells Fargo Bank, N.A.* (WD Wisc, June 22, 2009, No. 08-C-0223) 2009 US Dist Lexis 52282; *Djordjevich v Dexia Real Estate Capital Mkts.* (D Ariz, Nov. 7, 2008, No. CV-08-0288-PHX-DGC) 2008 US Dist Lexis 91253. See §2.10.

A bankruptcy court in the Second Circuit has held that the *Entz-White* rule promulgated by the Ninth Circuit Court of Appeals and relating to the payment of default interest by a bankrupt debtor is superseded by federal statute. See *In re Adejobi* (Bankr ED NY 2009) 404 BR 78, 81, discussed in §3.36.

In 2008, the California Legislature passed the Perata Mortgage Relief Bill (SB 1137), Stats 2008, ch 69, which creates new requirements for notices of default and notices of sale that are not described in residential deeds of trust. See §4.60A.

In 2009, the legislature passed the California Foreclosure Prevention Act (Stats 2009, 2d Extra Sess, ch 4, §3), modifying the foreclosure process to provide an additional 90 days in which the parties may seek to work out a loan modification. See §4.60B.

The Legal Opinions Committee of the Section of Business Law of the American Bar Association adopted a *Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions,* which was reprinted at 63 Bus Law 1277 (2008). See §8.3.

Several recent cases have ruled on the legal status of loan servicers. See *Ocwen Loan Servicing, LLC v Branaman* (ND Miss 2008) 554 F Supp 2d 645, 651; *Oppong v First Union Mortgage Corp.* (3d Cir 2007) 215 Fed Appx 114; *In re Parsley* (Bankr SD Tex 2008) 384 BR 138; *Chase Manhattan Mortgage Corp. v Cordero* (SD Fla 2007) 361 BR 257, 262; discussed in §10.26.

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Cutoff Dates

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Introduction to Real Property Financing and Negotiating Techniques

Charles Locko

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I. SCOPE AND LIMIT OF CHAPTER

§1.1 A. Overview of Commercial Loan Process

This chapter provides an overview of the process of obtaining financing secured by commercial real property. The main purpose of this chapter is to alert the practitioner to issues arising at the outset of the loan transaction. The roles of both borrower's and lender's counsel in the loan process are discussed in detail. This chapter covers:

- The role of the loan broker (see §§1.4-1.7);
- Types and sources of financing (see §§1.9-1.24);
- Definitions of commonly used terms (see §§1.25-1.53);
- A brief overview of usury issues (see §1.58);
- Concerns of lender's counsel (see §§1.60-1.66);
- Concerns of borrower's counsel (see §§1.67-1.71);
- Negotiating techniques for specific loan terms (see §§1.72-1.89); and
- The advantages, disadvantages, and requirements of conduit financing (see §§1.90-1.107; see also chap 10).

For an excellent discussion of issues a borrower's counsel must address in obtaining, negotiating, and closing a commercial real estate loan, see Carey, *Representing a Borrower in Commercial Real Estate Secured Financing*, 23 CEB Real Prop L Rep 158 (May 2000) [Part I: Getting Started], 23 CEB Real Prop L Rep 195 (July 2000) [Part II: The Big Issues and More].

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.2 B. Residential Loans

§1.2 B. Residential Loans

This book does not discuss the specifics of loans secured by residential real estate (other than multifamily, non-owner-occupied property), primarily because the typical homeowner lacks the bargaining power to affect the lender's underwriting and administrative policies. Moreover, residential lenders are typically constrained by state or federal law or regulations, or by the underwriting and other criteria of the Federal National Mortgage Association (FNMA). All loans purchased by the FNMA from the originating lender must meet FNMA standards. For a discussion of FNMA criteria for residential loans secured by units in common interest developments, see Forming California Common Interest Developments, chap 5 (Cal CEB 2004).

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§1.3 II. LOAN BROKERS AND OTHER CONSULTANTS

Loan brokers are useful for all but the most sophisticated borrowers. Generally the borrower lacks the time, resources, or knowledge of the lending marketplace to pursue financing without assistance. In addition, with tiered financing (mortgage, mezzanine, preferred equity) becoming more common, especially when the total principal amount is sizable, loan brokers often have relationships with several types of lenders that the borrower does not.

Viewed from a purely economic perspective, loan brokers will argue (often correctly) that their fees are no greater than the cost the borrower would incur in finding and arranging a loan on its own. In this sense, a loan broker can be helpful (and sometimes essential) to procure and close a commercial real estate loan. The enterprise undertaken by the loan broker, consultants, lender, and borrower is best viewed as a partnership, with the various "partners" (even opposing counsel) contributing their expertise and efforts in varying degrees to achieve a closing. Counsel for both borrower and lender should manage these participants to take advantage of their experience and work product in order to ensure that each task is accomplished in a timely fashion.

For further discussion of mortgage loan brokers, see California Real Estate Brokers: Law and Litigation, chap 8 (Cal CEB 2009); California Real Property Sales Transactions, chap 2 (4th ed Cal CEB 2007).

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§1.4 A. Role of Broker

Often, the prospective borrower, or its counsel, first contacts a loan broker to initiate the financing process. The term "loan broker" generally refers to independent mortgage loan brokers as well as mortgage bankers. An independent mortgage loan broker represents the borrower in finding and arranging secured financing appropriate to the borrower's project. Mortgage bankers represent one or more lenders offering a spectrum of loan "products" that vary in type, amount, term, and character and class of security. Certain lenders have developed an expertise in promptly and efficiently underwriting certain types of security (*e.g.,* hotel properties); others provide funding for specific purposes such as construction loans (see chap 9), bridge loans (see §1.15), or mezzanine financing (see §1.16). Loan brokers are also familiar with the financing marketplace. After learning about the property and business that will secure the loan, a broker can advise the borrower of the generally available loan amount, interest rate, and terms, and the underwriting criteria, credit enhancements, and borrower covenants necessary to procure the desired financing. On lenders' requirements for loans, see §§2.4-2.6. On brokers' duties, see California Real Estate Brokers: Law and Litigation, chaps 2-4 (Cal CEB 2009).

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§1.5 1. Fees and Costs Charged by Broker

The fee charged by the broker is typically based on "points" (each "point" equals 1 percent of the loan amount; see §1.49) and generally is not earned or payable until the loan closing. The broker may ask the borrower to reimburse certain expenses incurred in preparing a "work-up" of the property to make a favorable presentation to lenders. This arrangement benefits the borrower in two ways:

- The broker is not paid unless the borrower receives the loan proceeds; and
- Because the broker's compensation is tied to the loan amount, the broker has an interest in procuring the highest reasonable loan amount.

On broker compensation, see California Real Estate Brokers: Law and Litigation, chap 7 (Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.6 2. Loan Packaging

§1.6 2. Loan Packaging

Loan brokers are generally responsible for properly "packaging" the key financial and other information about the borrower and the property in a format that is readily accessible to the lender. This service will expedite the loan process because lenders are disinclined to consider an incomplete application.

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§1.7 3. Broker as Negotiator on Borrower's Behalf

In years past, loan brokers frequently assisted in negotiating certain business terms on behalf of the borrower, using the broker's ongoing personal relationship with the lender and familiarity with its policies. In conduit financing transactions (see §§1.33, 1.90-1.107; chap 10), however, credit decisionmakers are less accessible to the broker and the loan terms and underwriting criteria are more rigid. As a result, the broker's ability to negotiate on the borrower's behalf has been sharply curtailed in a securitized loan context; now loan brokers generally introduce the parties and the principals and their counsel negotiate and document the loan. Loan brokers can still be quite helpful with portfolio lenders.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.8 B. Other Consultants and Professionals

§1.8 B. Other Consultants and Professionals

In addition to the loan broker (if any), borrower's counsel should assemble a team of other consultants or professionals, such as environmental consultants, mechanical and structural engineers, appraisers, title officers, and land surveyors, as needed to facilitate the procuring and closing of the loan. Before retaining any such party, however, counsel should prequalify them with the prospective lender, because its internal policies may govern their acceptability. For example, many lenders have a list of prequalified appraisers whose appraisals are generally accepted by the lender for purposes of calculating the loan amount.

When negotiating retention agreements with these consultants and professionals, borrower's counsel should require evidence of adequate insurance to support their indemnities of the borrower and oppose any undue limit on their liability.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.9 III. TYPES OF FINANCING TRANSACTIONS

§1.9 III. TYPES OF FINANCING TRANSACTIONS

Financing terms and underwriting criteria vary, depending on the purpose of the loan and the nature of the property securing it. The major types of commercial loan transactions include the following:

- Acquisition (see §§1.10-1.13);
- Construction (see chap 9);
- Refinancing (see §1.14);
- Bridge and gap financing (see §1.15); and
- Mezzanine financing (see §1.16).

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§1.10 A. Acquisition

One of the more common real estate loan transactions is an "acquisition" loan. Generally, acquisition financing is the debt incurred by a buyer to finance the purchase of existing commercial property or property to be developed. On one hand, the lender's and the borrower's interests are closely aligned in an acquisition loan in that both parties are making an investment in the property, in which they hope to realize a profitable return. On the other hand, the borrower often desires a higher loan amount than the lender proposes because the borrower can maximize its return by minimizing its equity investment, while the lender seeks to minimize its risk through a more conservative loan-to-value ratio (see §1.44).

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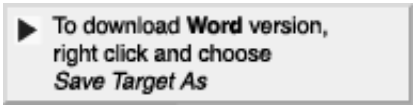
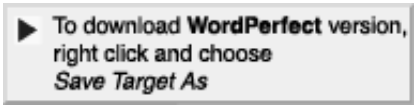
§1.11 1. Checklist: Due Diligence





Because the parties' investment objectives are aligned, the borrower's due diligence investigation should parallel that of the lender. Both the borrower and the lender should confirm the following information on the property being acquired:

- The operating history (*i.e.,* financial performance) of the property
- Its physical condition and prior use
- Its market value (generally by comparable sales or as a function of the property's cash flow)
- The continued enforceability of leases and service contracts, if any (or the ability to terminate them if so desired)
- The existence and status of all required licenses and permits
- Environmental compliance
- Zoning and other land use designations
- Title matters

For a detailed discussion of due diligence, see California Real Property Sales Transactions, chap 1 (4th ed Cal CEB 2007); for form due diligence checklists, see Real Property Sales, Apps B and C.

Recently, loan commitments have evolved (or devolved) into unenforceable "expressions of interest," or mere loan applications, deferring the lender's true commitment to lend until much later in the process (often, not until the final loan documents are fully negotiated). As a result, the borrower should be especially diligent in its evaluation of the business opportunity in order to avoid being obligated to purchase the property while the lender either denies the loan or offers a drastically reduced loan amount or a loan at an increased interest rate (commonly know as "resizing the loan"). For a detailed discussion of loan commitments, see chap 2.

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§1.12 2. Seller Financing

Occasionally, to facilitate an acquisition, the seller takes back a promissory note for all or part of the purchase price secured by a deed of trust against the property purchased. Except on rare occasions when the seller is the only lender, seller financing is generally short term and secured by a junior lien. If the security is an existing commercial project, seller financing functions much like bridge or gap financing (see §1.15), allowing the buyer to purchase the property at the seller's desired price when the buyer's primary acquisition financing is insufficient. If the security is unimproved property, sometimes the seller finances the land portion of the proposed development project, while the buyer looks to a more traditional source for the construction financing. In either event, the seller is required to subordinate its lien to the buyer's primary loan. If the seller is providing any financing, seller's counsel should inform the seller of the antideficiency protection afforded to buyers under CCP §580b, and buyer's counsel should advise the buyer about the exceptions to that protection. On drafting a deed of trust, see chap 4. For an extensive discussion of California's antideficiency statutes, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5 (4th ed Cal CEB 2009). For a detailed discussion of seller financing, see California Real Property Sales Transactions, chap 9 (4th ed Cal CEB 2007). For discussion of financing unimproved property, see Ground Lease Practice (2d ed Cal CEB 2009).

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§1.13 3. Ground Leases

As an alternative to a land purchase, a prospective buyer might finance an acquisition by entering into a ground lease with the seller. Ground leases are most often used when the buyer intends to develop raw land. Like a financing seller, the ground lessor facilitates the acquisition (of possession, rather than title) of the property by financing the land component of the project. Also like a financing seller, the ground lessor must usually subordinate its interest in the ground lease to the lender providing development and construction financing. Unlike seller financing, however, ground leases are typically long-term arrangements, ranging from 25 to 99 years. For a detailed discussion of ground leases, see Ground Lease Practice (2d ed Cal CEB 2009).

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§1.14 B. Refinancing

Refinancing an existing secured loan typically occurs for one or more of the following reasons:

- Availability of an increased loan amount or reduced interest rate;
- Changes in the amortization of principal; or
- Pending maturity of the existing loan.

When faced with upcoming maturity of the existing loan, the borrower will need to find replacement financing unless the borrower has sufficient capital from other sources to repay the loan or is willing and able to sell the property. Because refinancing normally involves significant expense (*e.g.*, loan fees, title premiums, escrow fees, consultant and legal fees, and, possibly, prepayment fees), the borrower must carefully calculate the economic benefits of a new loan.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.15 C. Bridge and Gap Financing

§1.15 C. Bridge and Gap Financing

"Bridge" and "gap" financing are terms used more or less interchangeably to describe loans that are typically meant for specific, short-term purposes to "bridge the gap" when the initial financing plan provides inadequate proceeds for the borrower's needs.

Gap financing generally refers to financing that fills a temporary funding shortfall (*e.g.,* when the amount of the senior take-out loan is insufficient to pay off the construction loan). It is frequently secured by a junior deed of trust.

Financing for the period between the completion of construction and the acquisition of desirable permanent financing, before the property is leased (*e.g.*, new office building) or otherwise achieves stabilization (*e.g.,* new hotel), is usually called bridge financing, or sometimes a "mini-perm." In this instance, the bridge loan has first priority and generally lasts three years or less. Bridge or gap financing is usually expensive because of the lender's increased risk. Because the need for this type of financing is often unanticipated, the borrower has limited bargaining power to negotiate favorable terms or pricing.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.16 D. Mezzanine Financing

§1.16 D. Mezzanine Financing

"Mezzanine" (*i.e.*, "middle") financing resembles bridge or gap financing (*i.e.,* additional debt inserted between the first lien and the owner's equity), but it usually serves a different purpose. The mezzanine debt structure is increasingly selected as an alternative to traditional financing (*i.e.,* 80 percent loan-to-value ratio, first deed of trust) because it provides a greater return to the borrower by using two tiers of debt, obtained from lenders with different investment objectives and tolerances for risk.

EXAMPLE 1: Assume that a borrower wants to acquire a $10 million property that has a cash flow of $100,000 per month before debt service. If the borrower obtains a nonrecourse (see §1.51), first-lien loan for 80 percent of the value of the property (*i.e*., $8 million), the interest payments at 9 percent on the $8 million loan would be $60,000 per month, and the lender would bear the risk of any loss greater than 20 percent of the property's initial market value if it is forced to foreclose after default. Alternatively, if the borrower obtains a first loan for only 60 percent of the property's value (*i.e.,* $6 million), the lender would be insulated from loss up to 40 percent of the property's initial market value, and thus might accept a 7-percent interest rate, resulting in interest payments of $35,000 per month on the first loan. If the borrower obtains a mezzanine loan for the remaining $2 million at 12 percent (because the mezzanine lender assumes the higher risk of loss), monthly interest would be an additional $20,000, resulting in total monthly debt service of $55,000, for a savings of $5000 per month over traditional financing.

EXAMPLE 2: Assume the same facts as in Example 1. As a further option, if the project's cash flow supports an adequate debt service coverage ratio (see §1.36) on the entire debt package, the borrower may be able to increase its leverage by obtaining a $3 million mezzanine loan (instead of $2 million) at 14 percent. In that event, the lender accepts a more aggressive loan-to-value ratio (the two loans together total 90 percent of the value of the property, instead of 80 percent) in return for the increased yield (double the 7-percent yield given to the more secure first lien holder). The financing structure outlined in this example provides an annual 36 percent ($360,000 divided by $1 million) cash on cash return to the borrower, which is a marked increase over the 27 percent ($540,000 divided by $2 million) return obtained in Example 1.

Often, the character of the mezzanine debt becomes something of a hybrid of debt and equity. For example, the first lienholder would probably require that debt service payments on the mezzanine loan be made only to the extent that cash flow is available (or possibly tied to a share in the equity) and that the security be limited to an interest in the borrower entity, instead of the real property. Mezzanine financing sometimes takes the form of a preferred equity investment, with the right to convert a passive interest into management and control as one of the lenders' remedies on default. There are many variations on this theme that may be used to achieve the objectives of the lenders and the borrower. Tax, accounting, and lender liability issues may also be involved, depending on the structure. See Murray, *Filling the Gaps: The Use of Mezzanine Financing in Real Property Transactions*, 15 Cal Real Prop J 3 (Summer 1997).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.17 IV. SOURCES OF FINANCING

§1.17 IV. SOURCES OF FINANCING

The following sections (see §§1.18-1.24) provide an overview of the various types of lenders that customarily make commercial real estate loans and the types of loans favored by each. Certain lenders (*e.g.*, banks, savings and loans, and insurance companies) are subject to regulations governing a number of issues, including the amount of money they may devote to commercial real estate loans—both in the aggregate and to any particular borrower. Regulated lenders may also be required to comply with certain underwriting guidelines (*e.g.,* appraisal) or periodically to recalculate reserves for loan losses based on the performance of their borrowers (whether or not in default), which requires ongoing monitoring of the borrower's financial statements.

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§1.18 A. Main Street Versus Wall Street: Portfolio Versus Conduit Lending

Traditional sources for nonconstruction commercial real estate financing include state or federally chartered banks and savings and loans, life insurance companies, and pension funds. These sources, known as Main Street lenders, typically hold a large proportion of the loans they originate in their portfolio of investments. In recent years, these "portfolio" lenders were increasingly replaced by (or themselves became) lenders that underwrite, negotiate, and fund the loans, before selling them to third party investors, such as mortgage bankers, financial institutions, or investment houses. These Wall Street institutions then package pools of mortgages and deeds of trust into commercial mortgage-backed securities (CMBS). In this respect, the originators of these types of loans, which are not held in their portfolios for any appreciable length of time, are mere conduits. The term "conduit loan" is generally used in the Wall Street, or CMBS, context (see §1.33). Owing to the need for uniformity in conduit loan pools, there is typically little room for negotiation of underwriting criteria or loan documentation. Local commercial banks, savings banks, and thrifts (see §§1.19-1.20) continue, however, to make portfolio loans, as do insurance companies (see §1.21), pension funds (see §1.22), mortgage REITs (real estate investment trusts that invest in loans; see §1.23), credit companies (see §1.24), and other entities. The influence of conduit lenders on commercial lending, even in the portfolio context, is pervasive because Main Street lenders have largely adopted the underwriting and documentation policies of the conduit market. For a detailed discussion of conduit financing, see §§1.90-1.107 and chap 10.

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§1.19 B. Commercial Banks

In the area of real estate finance, commercial banks have traditionally provided construction financing and relatively short-term permanent ("mini-perm") financing for existing real estate projects in their local markets. Smaller, local commercial banks generally provide long-term real estate financing only to their corporate business clients as part of a package of services, including unsecured credit lines and financing secured by inventory or other personal property. In contrast, the larger state or national banks provide all types of financing services to consumers and businesses alike.

National banks are subject to supervision and regulation by the Office of the Comptroller of the Currency and are subject to the National Bank Act (12 USC §§1-216d). National banks may lend on the security of real property, subject to limitations prescribed by order, rule, or regulation of the Comptroller. 12 USC §§371(a), 1828(o); 12 CFR §§34.1-34.87. Although they are members of the Federal Reserve System and are insured by the Federal Deposit Insurance Corporation (FDIC), they are not subject to supervision or general regulation by the FDIC or the Board of Governors of the Federal Reserve System, but a limited number of specific regulations of the FDIC and the Board of Governors of the Federal Reserve System apply to national banks. See, *e.g.,* 12 USC §§3331-3351; 12 CFR §§34.61-34.62, 201.1-281.1, 365.1-365.2.

State banks that are members of the Federal Reserve System are subject to regulation and supervision by the Board of Governors of the Federal Reserve System and the California Department of Financial Institutions (DFI). State banks that are not members of the Federal Reserve System, but are insured by the FDIC, are subject to regulation and supervision by the FDIC and the DFI. The type and the terms of loans made by California banks are governed by Fin C §§1200-1382.

State and federally chartered banks (whether in or outside of California) and certain foreign banks are exempt from California's usury law. Cal Const art XV, §1. For a detailed discussion of usury, see §§3.37-3.44.

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§1.20 C. Savings and Loans; Savings Banks; Thrifts

Savings and loan associations were created primarily to provide home financing to private consumers. Over time, they also became an important source of commercial real estate financing. The problems encountered by savings and loans in the 1980s (*e.g.,* massive write-offs in commercial real estate loans, losses from imprudent real estate investments, and costs of funds far exceeding return on existing, fixed-rate loans) decimated the industry, resulting in increased federal regulation (The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Pub L 101-73, 103 Stat 73)) of both federal and state chartered savings and loans, savings banks, and thrifts. For example, savings and loans, which were once permitted to leverage their capital as much as 33 times, are now limited to holding nonresidential real estate loans at no more than 4 times their capital base. 12 USC §1464(c)(2)(B).

Although the savings and loan industry is not the factor it once was, it continues to make both commercial real estate and traditional home loans, relying largely on consumer deposits as a funding source. Like banks, they are exempt from California's usury law. Cal Const art XV, §1. See §3.39.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.21 D. Life Insurance Companies

§1.21 D. Life Insurance Companies

For decades, life insurance companies have been a mainstay in commercial real estate lending, frequently being a source for larger scale financings because of their typically large capital base. Although a number of life insurance companies continue to lend to individual commercial borrowers, an increasing portion of their real estate loan portfolio is in commercial mortgage-backed securities (conduit loan pools; see §§1.18, 10.1). These investments typically generate a higher yield than traditional insurance company investments (*e.g.,* government securities and corporate bonds) without requiring additional staffing to procure, underwrite, and administer individual loans and without tying up capital for a long period.

Life insurance companies are subject to state charters regulating their investment activity (including the types of loans made and underwriting standards) and are exempt from California usury laws. On regulation of insurance companies, see Ins C §§1190-1202; on exemption from usury laws, see Cal Const art XV, §1.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.22 E. Pension Plans

§1.22 E. Pension Plans

Pension plans are also an important source for commercial real estate financing, although their tolerance for risk is circumscribed by both internal policies and government regulations. See, *e.g.,* 29 CFR §2510.3-2(a). All "qualified plans," including pension funds, are subject to the Employee Retirement Income Security Act (ERISA) (29 USC §§1001-1461), which adds another layer of complexity to the selection of borrowers and to loan documentation and limits the parties' flexibility in structuring the transaction. For example, the pension fund lender may impose ERISA requirements that affect the borrower's operations, such as prohibiting leases to certain tenants. See 29 USC §1106(1)(A); IRC §4975(c)(1)(A). See also 29 USC §§1101-1114.

See §3.39 for discussion of pension funds and usury.

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§1.23 F. Mortgage REITs

Real estate investment trusts (REITs) are tax-advantaged investment vehicles that must follow strict guidelines to preserve their status. Some REITs invest in equity interests in real estate, while mortgage REITs make loans secured by real estate. The types and amounts of loans made by REITs are governed by the trust's internal documents, and federal tax laws limit the way mortgage REITs can structure their loan transactions. See IRC §§856-859.

EXAMPLE: A REIT may attempt to restrict how the borrower conducts its business (*e.g.*, limiting the borrower's sublease profit, common area maintenance profit, and other types of income). See IRC §§512, 856.

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§1.24 G. Industrial Loan Companies; Finance Companies; Other Lenders

Industrial loan companies and finance or credit companies are regulated under California law but are exempt from California usury laws. See Fin C §§18000-18707, 22000-22780. See §3.39. Many other nonbank lenders, investment bankers, or even wealthy individuals are willing to make loans secured by real property.

Nonbank lenders (*e.g.,* mortgage bankers) who originate loans usually fund them from "warehouse" lines of credit (as opposed to their own capital or deposit accounts) and then resell the loans to others, either in pools or otherwise. These lines of credit are called "warehouse" because the originating lenders use the lines to fund loans that will be "stored" until the pool of loans is large enough to be sold and securitized in the CMBS market (see §§1.18, 1.33, 1.90-1.107; chap 10). Frequently, these warehouse lines are made available by the party that will purchase the pool of loans funded by the line of credit, and the proceeds are used to replenish the line. Sometimes the line cannot be used to fund a particular loan until it (including the yield on principal) is approved by, and the originating lender is otherwise in good standing with, the provider of the line. The further removed an originating lender is from the ultimate source of funds, the greater the risk that the loan funds will not be there at closing. Although the risk is greater in times of interest rate volatility, it is always in the borrower's best interest to know the lender.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.25 V. TERMS USED IN REAL PROPERTY FINANCING

§1.25 V. TERMS USED IN REAL PROPERTY FINANCING

To assist the reader in understanding the secured loan vernacular, and to provide a quick reference for the concepts discussed in detail in this book, §§1.26-1.53 provide brief definitions of frequently used terms.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.26 A. Adjustable (or Variable) Pay Loan

§1.26 A. Adjustable (or Variable) Pay Loan

Adjustable or variable pay loans have payment terms that permit different levels of debt service at different times. Loans for commercial buildings that are new to the market frequently contain variable pay rates that reflect the particular circumstances.

EXAMPLE: After the construction or rehabilitation phase of a project, there is usually a period of relative underperformance while the borrower seeks tenants. Before reaching full occupancy, the project may be able to pay interest only (or may not even be able to pay all of the interest accruing) for some time. By allowing interest-only payments before converting to an amortizing loan, an adjustable or variable pay loan recognizes the economic realities of the project securing the loan, while satisfying the lender's expectations of full debt service.

A variable pay loan may have either a fixed or an adjustable interest rate. See §1.27.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.27 B. Adjustable (or Variable) Rate Loan

§1.27 B. Adjustable (or Variable) Rate Loan

Adjustable rate loans have interest rates that change over the term of the loan, based on the index rate to which the loan is tied. The most common indexes or reference rates used for adjustable rate loans include the prime rate (which varies among lenders), the London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds Index (COFI), and Treasury bills. The interest rate for the loan is calculated by adding basis points (see §1.29) or percentage points (the "spread" or "margin") to the index or reference rate. For further discussion of adjustable rate loans, see §§1.76-1.77.

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§1.28 C. Amortization

Amortization is the scheduled reduction of principal, paid in installments over time. As principal is reduced, the portion of any future installment payment allocable to interest on the principal is reduced accordingly. If the loan payment amount is fixed, the principal portion of each payment increases over time, further reducing interest accruals. Occasionally, commercial loans are fully amortizing, which means that the loan principal will have been paid in full at maturity. As a general rule, however, commercial loans are amortized over a 15- to 30-year period with a term of no more than 10 years, and sometimes as short as 3 years, thus requiring a balloon payment on the loan's due date. Although secured loans made by certain entities need not be amortized at all (*i.e.,* the payments consist of interest only), most lenders are required by the secondary market (*i.e.,* investors who buy existing loans) to make loans that amortize principal, thus increasing the security of the lender's position.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.29 D. Basis Points

§1.29 D. Basis Points

One basis point is 1/100 of a percentage point. Generally, the term "basis points" is used in the context of a spread between an interest rate index (*e.g.,* prime or LIBOR; see §1.27) and the rate charged to the borrower.

EXAMPLE: A rate based on the six-month LIBOR of 6 percent plus 175 basis points would be 7.75 percent.

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§1.30 E. Blanket Mortgage/Deed of Trust

Although true mortgages are rarely used in California, the term is often used interchangeably with deed of trust. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 1 (4th ed Cal CEB 2009). A blanket mortgage or deed of trust describes a single instrument that encumbers several parcels of land or, occasionally, secures more than one obligation. On problems peculiar to multiple security and multiple obligations, see Mortgage Deed of Trust Foreclosure, chap 9.

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§1.31 F. Bowtie Loan

A "bowtie loan" is a type of variable pay loan (see §1.26) under which the payments, at inception, are inadequate to pay all accruing interest. As the economic performance of the asset securing the loan increases, the payments increase, ultimately covering both interest and principal amortization. (If the loan payments and outstanding principal are plotted on a graph, the intersecting lines depict a bow tie.)

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§1.32 G. Bullet Loan

A "bullet loan" is a short-term, nonamortizing or partially amortizing loan. The term "bullet" refers to the fact that the borrower will soon be facing a significant principal payment "bullet" that the borrower will have to refinance or otherwise repay, or risk default. Usually prevalent during periods of interest rate instability or uncertainty, bullet loans are used by lenders unwilling to commit funds for an extended period and by borrowers willing to accept the refinancing risk in order to obtain short-term financing.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.33 H. Conduit Loan/Securitized Loan

§1.33 H. Conduit Loan/Securitized Loan

Securitized or "conduit" loans are commercial loans that are pooled together and in which interests are sold as securities (commercial mortgage-backed securities, or CMBS) in the capital markets. Because the originating lender does not hold this type of loan in its portfolio, it acts as a "conduit" between the borrower and the ultimate source of the loan funds. To make commercial loans fungible, conduit loans are subject to uniform underwriting standards and conforming documentation. For a full discussion of conduit loans, see §§1.90-1.107 and chap 10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.34 I. Convertible Loan

§1.34 I. Convertible Loan

The term "convertible loan" has different meanings, depending on the context in which it is used. A convertible loan sometimes means a loan whose provisions change, depending on the status of the underlying security. For example, a loan may convert from a construction loan that has a high, variable interest rate, no current payments, and a short term, to a permanent loan with a lower, fixed interest rate, amortized payments, and a longer term, after the property becomes (or should become) income producing.

Another type of convertible loan gives the lender (or, sometimes, the borrower) the option to convert all or part of outstanding principal to an equity interest in the borrower. Although less common today, such loans have historically been popular when traditional interest rates are high or capital is scarce, when debt financing is either uneconomic or unavailable, or when an unconventional project presents a high risk to both lender and borrower but also presents an opportunity for very high returns if successful. See also §1.52 on shared appreciation loans. Occasionally, the convertible option is used in mezzanine financing schemes. On mezzanine financing, see §1.16.

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§1.35 J. Cross-Collateral/Cross-Default

The concepts of cross-default and cross-collateral, often used in tandem, generally apply when a single lender carries more than one loan with the same borrower (or affiliates of that borrower). Cross-default in this context means that, if a borrower defaults under one loan with the lender (or any other obligation owed by the borrower to the lender), the borrower is also considered to be in default under one or more other loans. Other cross-default provisions consider a borrower to be in default under a loan from its lender if the borrower is in default under a loan from an unrelated lender (whether or not that separate obligation is secured by property also securing the first lender's loan).

Cross-collateral means that, although certain described real property is security for one loan, it can also be called on to satisfy a different obligation owed to the same lender.

Cross-default and cross-collateral provisions are sometimes called "dragnet clauses" because they reach what would otherwise be unrelated obligations or collateral and tie them to the subject transaction. Lenders frequently insist on these provisions, but they do not benefit the borrower (except, arguably, by increasing the availability of financing to the borrower). Lenders expecting to include these provisions in documents evidencing or enforcing a loan should obtain the borrower's prior approval. See *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.36 K. Debt Service Coverage Ratio

§1.36 K. Debt Service Coverage Ratio

Debt service coverage ratio is the ratio between the annual debt service (principal and interest or, for capital leases, secured loan and lease payments) and the annual net operating income from the encumbered property. Along with loan-to-value ratio (see §1.44), debt service coverage ratio is a key underwriting criterion for lenders. Typically stated in relation to the number one (*e.g.,* 1.10 to 1, 1.15 to 1), debt service coverage ratio refers to a project's ability to pay debt service after paying all (or most) other regular expenses. A debt service coverage ratio of 1.10 to 1 means that the property's cash flow for a given period (*e.g.,* monthly or annually) exceeds debt service for the same period by 10 percent.

The ratio required by a lender will always exceed 1 because a lender always requires that cash flow be sufficient to pay debt service on a current basis. Generally, the amount by which a lender requires the ratio to exceed 1 depends on the perceived risk that the property's cash flow will decline in the future owing to business downturns, increased operating expenses, capital expenditure requirements, and the like. Sometimes, if the parties generally agree on the project's operating projections, the lender may accept a lower debt service coverage ratio (and a larger loan amount) if the borrower is willing to pay a higher interest rate.

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§1.37 L. Earnout

"Earnout" refers to the ability of a project (*e.g.,* a new retail mall) to qualify for an additional principal disbursement previously negotiated under the loan documents. The operating performance of a project generally improves as the amount of leased space increases. When this improved performance reaches a certain point, the project "earns" additional principal (often representing a portion of the developer's profit) that the lender was reluctant to disburse at the outset because of the uncertainty of the projected performance. Earnout loans, available from some portfolio lenders, provide greater flexibility than conduit loans, which typically extend for five years or more and prohibit prepayment. An earnout loan permits a borrower with an unseasoned project to incrementally increase its leverage (and the return on its equity) before stabilization, at which time the earnout loan is replaced.

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§1.38 M. Grace Period

A grace period is the time following the stated due date during which a borrower may pay a scheduled installment without being considered in default or suffering any other sanction (*e.g.,* late charges, default interest). This period protects the borrower, who rarely wishes to pay early, when the payment is unexpectedly delayed (*e.g.,* slow mail). For negotiating techniques regarding grace periods, see §1.80.

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§1.39 N. Guaranty

A guarantor is "one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor." CC §2787. Lenders often request guaranties from interested third parties (*e.g.,* the borrower's principals or affiliates) as added assurance for repayment of the debt and for performance of the borrower's related obligations under the loan. The scope of a guaranty can range from a comprehensive guaranty of payment (including interest installments, the entire outstanding principal, and all other charges against the property, such as property taxes) to a mere affirmation of personal liability for certain limited exceptions to an otherwise nonrecourse loan (see §1.51).

The following are various types of guaranties:

- "Carry" guaranties are generally limited to scheduled interest payments or operating expenses related to the security for a specified period of time (usually some months beyond the maturity date), rather than any obligation to repay principal.
- "Bad boy" guaranties are limited to specified acts of wrongdoing, such as fraud or misrepresentation at the inception of the loan (in which case the guarantor would be liable for full repayment) or misapplication of insurance or condemnation proceeds (in which case the liability is limited to the misapplied amounts).
- "Springing" or "exploding" guaranties are frequently used to discourage the borrower (or any of its principals) from taking legal action to delay the lender's realization on the security. See §6.45C.
    - Springing guaranties have no present effect on execution but become effective on the occurrence of a subsequent event considered prejudicial to the lender, such as a bankruptcy filing or contested foreclosure.
    - Exploding guaranties are valid on execution but expire on satisfaction of a condition subsequent, such as an uncontested foreclosure.

A guaranty is a common form of credit enhancement (see §1.59). Although guaranties are a valuable tool for both lender and borrower in procuring the most attractive loan from an economic standpoint, they expose both parties to substantial risks and should be carefully analyzed and negotiated as fully as circumstances permit. For a detailed discussion of guaranties, see chap 6; California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.40 O. Impound Account

§1.40 O. Impound Account

Impounds are regular deposits, paid together with scheduled debt service, to defray future property expenses such as taxes and insurance premiums. Impounds are sometimes established for other purposes, such as reserves. On reserve accounts, see §1.89. For negotiating techniques regarding impound accounts, see §1.88.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.41 P. Interest

§1.41 P. Interest

Interest payable on a loan is the price paid to the lender for its extension of credit to the borrower. Interest is typically measured as an annual percentage of the principal balance of the loan, is payable in scheduled installments (*e.g.,* monthly, quarterly), and can be fixed or adjustable in rate. On adjustable (or variable) rates, see §1.27. For negotiating techniques regarding the interest rate, see §§1.75-1.77.

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§1.42 Q. Loan Participation/Loan Syndicate

Occasionally, the size of the loan or the nature of the security indicates that the risk of the loan should be shared among several lenders, each of whom funds a portion of, or "participates" in, the loan. In a participated loan, the lead lender acts as the agent for the lender group, locates the loan opportunity, underwrites the loan, undertakes appropriate due diligence, negotiates the loan documents, and sometimes funds the entire principal (*i.e.*, "originates" the loan), which is partially repaid by the participants on syndication. (Participants may also purchase their respective interests concurrently with loan funding.) The lead lender always maintains a position in the participated loan, usually at least 25 percent. For undertaking this role, the lead lender receives compensation from the other lenders by keeping all or a substantial portion of the loan fees, retaining the loan servicing for an additional fee, or both. On loan servicing, see §1.43.

Loan syndicates are similar to participations in their origination and administration, but each lender in the syndicate is liable to the borrower to provide only its own commitment amount, adding yet another layer of complexity to the transaction. In a loan syndicate, the borrower must assure itself that each lender is ready, willing, and able to supply its share of the loan funds.

WARNING: In recent years, many financial institutions have been sold or merged with others. A few have collapsed entirely. Tracing the identity of the lead lender on a specific loan, the current holder of the promissory note and loan documentation, or the ultimate owner of the note can be difficult, but imperative. See, *e.g., In re Kang Jin Hwang* (Bankr CD Cal 2007) 396 BR 757, in which a bankruptcy court refused to allow the holder (and servicer) of a note to proceed with its foreclosure action without joining the "owners" of the note. The note had been resold several times through securitized pools and the ultimate owners could not be identified. See also Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine,* 35 Creighton L Rev 50 (Apr. 2002).

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§1.43 R. Loan Servicing

"Loan servicing" is the administration of a loan after it has been funded. Loan servicing functions include keeping track of loan payments, assuring that real property taxes and hazard insurance premiums are paid, confirming compliance with operating covenants, and handling loan default situations. In the recent past, commercial loans were typically kept in the portfolio of the originating lender, who customarily serviced its own loan. Today, the loan servicing function is often divorced from the loan holder and is performed by a separate or related entity known as a "loan servicer." The loan holder sacrifices a fraction of an interest point for the convenience of simply depositing the loan payments collected by the loan servicer. In conduit financing (see §§1.33, 10.1), loan servicing is never handled by the holders of interests in the mortgage pool, and the originating lender frequently retains the right to service the loan.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.43A S. Loan-to-Cost Ratio

§1.43A S. Loan-to-Cost Ratio

"Loan-to-cost" is the ratio of the maximum amount the lender is willing to loan to the total construction costs, stated as a percentage. See §9.4.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.44 T. Loan-to-Value Ratio

§1.44 T. Loan-to-Value Ratio

"Loan-to-value" is the ratio of the loan amount to the estimated value of the encumbered real property (set by the lender or an independent appraiser), stated as a percentage.

EXAMPLE: If a lender requires an 80-percent loan-to-value ratio, and the estimated value of the property is $1 million, the loan amount will not exceed $800,000 (80 percent of $1 million).

Because the property is the main (and sometimes only) recourse for the lender if the borrower fails to repay the loan (see §1.51), the required loan-to-value ratio is always less than 100 percent. Lenders accept a higher loan-to-value ratio for stabilized, improved commercial property than for raw land or property being (or only recently) developed, to reflect the relatively limited market for real property that is not income producing.

A prudent loan-to-value ratio provides a cushion to the lender if the encumbered property is overvalued when the loan is made, or if the value declines in an economic downturn. It also assures that the borrower has an ongoing interest in the viability of the property because a substantial portion of the borrower's equity remains tied up in the property.

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§1.45 U. Lock Box

A "lock box" is a common mechanism in conduit loans in which the cash receipts are swept from the borrower's operating account on a regular basis (as often as every business day) into a bank account that is in the borrower's name but is controlled by the lender. The funds in the account are administered by the loan servicer in accordance with a cash management agreement among the lender, the borrower, and the bank holding the account. Expenses relating to the real property security, including debt service, tax and insurance impounds, and deposits to reserves, are paid directly from this account; the remainder is made available to the borrower for cash flow purposes. Since the lock box assures the lender that operating revenues will be properly applied, it is even used in operating businesses (*e.g.,* office complexes, retail shopping centers, or hotels), even though it can make the borrower's cash flow management extremely difficult. It is ineffective in owner-user situations.

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§1.46 V. Lock-In Clause

A "lock-in clause" in a loan prohibits (or makes prohibitively expensive) loan prepayment before the expiration of a certain period (*e.g.,* before the date when a CMBS loan is securitized) or before the scheduled maturity date. When paired with a due-on-sale clause and a due-on-encumbrance clause (both common in commercial real property loans —sometimes collectively called a due-on-transfer clause), a lock-in clause prevents a borrower from either extracting surplus equity from the property or refinancing to take advantage of lower interest rates: the borrower is "locked in."

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.47 W. Mezzanine Financing

§1.47 W. Mezzanine Financing

"Mezzanine financing" is financing provided between the borrower's equity and debt secured by a first deed of trust, frequently taking on the characteristics of both debt and equity. See §1.16.

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§1.48 X. Pay Rate

"Pay rate" is the regularly scheduled debt service required under the loan. Although most repayment schemes incorporate amortization (retirement) (see §1.28) of principal and interest, the pay rate occasionally varies to accommodate the borrower's business plan or the economic realities of the real estate project securing the loan.

EXAMPLE: If the long-term prospects for the project are strong but the short-term cash flow is weak, the pay rate may provide for payments of interest only, or even partial interest (negative amortization), in the short term (*e.g.,* during a lease-up period).

On loans with variable pay rates, see §1.26.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.49 Y. Points/Loan Fees

§1.49 Y. Points/Loan Fees

In addition to interest, commercial lenders almost always charge loan fees, which are generally expressed as "points." Each point equals 1 percent of the total loan amount. For example, a 2.5 point fee on a $1 million loan is $25,000. Points effectively raise the lender's yield because interest is earned on the gross loan amount even though the actual amount disbursed to the borrower is net of the points paid. Normally, points are also paid to the loan broker (if any) who arranged the loan.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.50 Z. Prepayment

§1.50 Z. Prepayment

"Prepayment" is the payment of loan principal before the scheduled maturity date. Although it may appear counterintuitive, a borrower has no inherent legal right to repay its debt before the time specified in the promissory note. *Gutzi Assocs. v Switzer* (1989) 215 CA3d 1636, 1644, 264 CR 538. See also CC §1490.

Prepayment rights are often conditioned on the borrower's payment of a fee. On calculating prepayment premiums, see §§1.86, 3.32. On prepayment generally, see §§3.22-3.34.

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§1.51 AA. Recourse/Nonrecourse

The term "recourse" means that the borrower has personal liability for the loan, thus permitting a deficiency judgment against the borrower if the property is sold at a judicial foreclosure sale for less than the amount owed to the lender. In a nonrecourse loan, the borrower has no personal liability and the lender's only recourse on default is foreclosure and sale of the property. Even in nonrecourse loans, however, borrowers are often personally liable for losses suffered by the lender as a result of improper conduct (*e.g.,* fraud, waste, misappropriation of funds), or for environmental damages (see §1.83). Commercial real property financing is frequently, but not always, nonrecourse.

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§1.52 BB. Shared Appreciation Loan

In a "shared appreciation loan," the lender receives a share of the expected increase in the value of the security during the loan term, in addition to the stated (usually fixed) rate of interest in the promissory note. If interest rates for a conventional loan are too high for the property to service, but the property is expected to appreciate substantially, the borrower may wish to give the lender a portion of the future appreciation in exchange for a lower interest rate. The lender, in return, receives a greater yield on its principal because the cash participation (when realized) is added to interest received over the term of the loan. Historically popular in times of tight capital or high interest rates, shared appreciation loans generally fall out of favor when loans are easily available and lenders are less apprehensive about interest rate volatility.

Tension can arise between the parties to a shared appreciation loan if the property performs well early in the loan term and the lender realizes its share of the capital appreciation only on sale, refinance, or maturity of the note. In that event, the lender wants the right to force a sale or refinancing, which could sharply reduce the borrower's return.

In lieu of a share of capital appreciation, the lender may be allocated a portion of the project's cash flow, which is analogous to an investor's preferred return, in addition to the stated interest on the loan. Despite the recent relative stability in interest rates, the shared appreciation concept has become popular again as an alternative way to compensate mezzanine lenders. On mezzanine financing, see §1.16. The usury issues that shared appreciation loans would otherwise raise are largely addressed by CC §1917.005.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.53 CC. Wraparound Deed of Trust/All-Inclusive Deed of Trust

§1.53 CC. Wraparound Deed of Trust/All-Inclusive Deed of Trust

A wraparound deed of trust is a security instrument that contemplates a subordinate loan arrangement between lender and borrower in which the payments required to be made to the wraparound lender include debt service on senior secured debt. The obligation includes or "wraps around" the principal amount of the senior loan, and payment of the obligation is "all inclusive" of the payments due under the senior loan.

Wraparound financing was popular in the late 1970s and early 1980s when interest rates rose into the high teens and sellers, in essence, sold the existing financing along with the property. Largely because of the increased incidence (and more certain enforceability) of due-on-sale and due-on-encumbrance clauses, wraparound financing is rarely used in commercial loan practice today. (Due-on-sale clauses are usually fully enforceable according to their terms under the Garn-St. Germain Depository Institutions Act of 1982 (Pub L 97-320, 96 Stat 1469).)

For further discussion of wraparound and all-inclusive deeds of trust, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009).

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VI. ROLE OF COUNSEL

§1.54 A. Importance of Early Involvement

The importance of counsel's participation (representing either the borrower or the lender) early in the loan process cannot be overemphasized. Several crucial issues arise at the outset of a transaction that, if ignored or decided without the proper level of analysis, could prove prejudicial to one of the parties or fatal to the transaction as initially conceived. All too often, counsel is first contacted after the loan commitment is executed, which usually means that most of the fundamental business and legal issues have been agreed on. Presented with a fait accompli, the lawyer's role is reduced to merely implementing the agreement expressed in the loan commitment. Although this role is still important, counsel's expertise is not being used to its full advantage. A prudent borrower or lender will obtain counsel's analysis and advice on the terms of the loan commitment *before* executing it, because several things generally happen on execution of the commitment:

- The parties expect the transaction to close as and when contemplated, without significant changes in the terms expressed in the commitment;
- The borrower has incurred a substantial commitment fee; and
- The borrower has obligated itself to defray due diligence expenses.

For a full discussion of loan commitments and the attorney's role in negotiating and drafting them, see chap 2.

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§1.55 1. Structuring the Transaction

The lender's attorney is often instrumental in structuring the financing transaction. Besides ensuring that the transaction meets the lender's internal requirements, the attorney must ensure that the loan, including the collateral pledged by the borrower or third parties and any guaranties provided to the lender, is designed not to interfere with the lender's remedies on default. For example, the attorney must be sure that the loan and the collateral package are structured with a view toward limits imposed on enforcement by the California one-action and other antideficiency rules, as well as limits imposed by California law on the enforceability of guaranties. See, respectively, California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5, 9 (4th ed Cal CEB 2009). The lender's attorney must also be mindful of regulatory restrictions affecting the lender.

Although the lender's attorney is usually responsible for structuring the transaction and drafting the loan documents, the borrower's counsel is usually responsible for coordinating matters required to close the loan, including obtaining any required third party consents, furnishing the required due diligence information, and resolving title insurance issues. On due diligence and title issues, see §1.70.

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§1.56 2. Preparing Initial Drafts

Lenders usually require that their own loan document forms be used, and the lender's attorney is ordinarily responsible for preparing initial drafts of the documents. Borrowers' attorneys rarely, if ever, draft the documents. The lender's attorney should ascertain whether the client has a preferred set of forms for its transactions; most institutional lenders, including banks, life insurance companies, and pension funds, have developed their own form documents. Nonetheless, counsel should be vigilant in confirming that the documents comply with current California law and in adapting the forms to reflect the terms of the specific transaction. Noninstitutional lenders are less likely to insist on using their own loan forms and often rely on their counsel to recommend the forms.

The role of the borrower's attorney is to review the lender's documents, comment on the provisions, and decide which issues should be negotiated. Because the lender may reject proposed changes, the borrower's attorney must advise the client of the effect of the form provision if the client elects to proceed to closing.

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§1.57 3. Use of Standard and Computerized Forms

Some financial institutions use standard printed forms developed by trade associations and other organizations. Private lenders sometimes use printed forms distributed by title insurance companies. Although these forms might be acceptable for relatively simple transactions, they are seldom used for more sophisticated loans. Even in simple transactions, counsel often needs to prepare addendums to the documents to include additional provisions (*e.g.*, due-on-sale clauses, prepayment provisions, and late charges).

Besides using standard forms, some institutions, such as smaller banks and middle-market lenders, purchase software capable of generating basic loan documents with alternative provisions available to the lender. Although these programs might be acceptable for relatively straightforward, nonnegotiated transactions, they are rarely used for complex financings or sophisticated transactions. The attorney working with computerized forms must usually prepare addendums to supplement the forms and to reflect the terms of a particular loan transaction.

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§1.58 B. Usury

California's usury law regulates the interest rate that can be charged by lenders that are not exempt from that law. The California Constitution prohibits lenders in commercial transactions from charging more than the higher of 10 percent per annum or 5 percent per annum in excess of the rate established by the Federal Reserve Bank of San Francisco for advances to its member banks (commonly called the "discount rate"). Cal Const art XV, §1.

The usury issue affects the lender because it may incur severe penalties if it violates the usury restrictions. The borrower may avoid *all* interest payable under the obligation, not just the usurious portion (*Winnett v Roberts* (1986) 179 CA3d 909, 225 CR 82), and may be entitled to recover treble damages on interest actually paid (*Wheeler v Superior Mortgage Co.* (1961) 196 CA2d 822, 17 CR 291). Moreover, any lender accepting usurious interest is guilty of a crime. West's CC §1916-3(b) (uncodified). Usury also concerns the borrower because the lender customarily requires the borrower's counsel to provide a written opinion that the transaction is not usurious. The analysis of the usury issue requires more than simply looking at the stated interest rate, because certain other monies paid to a lender (*e.g.,* fees paid to a lender for originating the loan) could be characterized as additional interest. See, *e.g., Forte v Nolfi* (1972) 25 CA3d 656, 102 CR 455. Counsel for both borrower and lender should ascertain either that the compensation paid to the lender does not exceed the maximum permitted or that the lender or transaction is exempt. For a thorough discussion of usury, including the statutory and constitutional exemptions from usury restrictions, see §§3.37-3.44. For a list of exempt loans and lenders, see §3.39. See also Lind, *A Real Estate Attorney's Guide to California Usury Laws*, 18 CEB Real Prop L Rep 271 (Oct. 1995).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.59 C. Credit Enhancement

§1.59 C. Credit Enhancement

To obtain the most favorable interest rate (or, in some cases, just to obtain the loan), the borrower may be required to provide additional assurances to the lender that the loan will be repaid as scheduled. The broad category of these devices is known as "credit enhancement." Credit enhancement can involve letters of credit, cash security, personal guaranties, and occasionally additional real property security. Counsel for both lender and borrower should discuss the nature of the additional security and whether the borrower is willing or able to comply. Skillful counsel on both sides can provide a valuable service to their clients in negotiating mutually agreeable security arrangements that reduce the lender's risk to an acceptable level while addressing the borrower's legitimate economic and other concerns. For negotiating techniques regarding various forms of credit enhancement, see §1.82.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.60 D. Concerns of Lender's Counsel

§1.60 D. Concerns of Lender's Counsel

Lender's counsel should consult the later chapters of this book for guidance on drafting the documents that evidence and secure the loan. Other issues, however, should be addressed early in the process. Depending on the lender's level of sophistication, counsel may be asked to advise the lender on several issues that might be considered business, rather than legal, matters. Examples of such issues are discussed in §§1.61-1.66.

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§1.61 1. Title Matters

A primary concern of lender's counsel is to confirm that the party executing the deed of trust securing the debt (usually the borrower) actually owns the security, as sole owner, with no senior liens or encumbrances except those acceptable to the lender. Occasionally, the party offering the security for the borrower's benefit is not the borrower (an accommodation party). The use of an accommodation party complicates collection remedies for the lender and should be approached with caution. For further discussion, see also §4.3.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.62 a. Preliminary Report

§1.62 a. Preliminary Report

Lender's counsel must scrutinize a preliminary report (or title commitment), together with copies of all enumerated exceptions (as opposed to the standard printed exceptions) in the report, to evaluate any covenants, conditions, restrictions, easements (both dominant and servient), or other matters affecting title. Because the lender may ultimately take title, or rely on the cash bid of a third party at a foreclosure sale, counsel should confirm that marketable title of the property can be conveyed to any subsequent owner. On review and analysis of preliminary reports, see California Title Insurance Practice, chap 5 (2d ed Cal CEB 1997).

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§1.63 b. ALTA Survey

Nearly every commercial loan transaction justifies (or requires by regulation) the preparation and analysis of an American Land Title Association (ALTA) survey, which graphically depicts the location of improvements, easements, and encroachments. In reviewing an ALTA survey, the primary concerns of lender's counsel are to confirm that

- the property described in the preliminary report and the property depicted in the survey are one and the same;
- the property is one or more legal lots (and if more than one lot, that they are contiguous);
- the improvements on the property do not encroach on easements within the property, or on setback lines or neighboring properties;
- improvements on adjacent parcels do not encroach on the property or its appurtenant easements;
- the property has adequate parking to serve its needs and to comply with local regulations;
- adequate vehicular access is available to the property; and
- all necessary utilities are available to the property line (*e.g.,* check for meters, junction boxes, etc.).

Counsel should also confirm (as with all consultants on whose reports the lender will rely) that the civil engineer preparing the report has sufficient financial resources and insurance to answer for any claim resulting from errors and omissions on the ALTA survey.

On ALTA surveys, see California Title Insurance Practice, chap 4 (2d ed Cal CEB 1997).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.64 c. Common Endorsements

§1.64 c. Common Endorsements

Lender's counsel should routinely ask for certain endorsements to title coverage (at borrower's expense) to indemnify the lender against losses or claims relating to the following:

- Mechanics' liens;
- Encroachments or easements on adjoining property;
- The effect of recorded covenants, conditions, and restrictions;
- Oil, gas, and mineral rights (if the title review reveals that these rights are not fully held by the borrower);
- Contiguity of the parcels composing the property;
- Variations between the property as described in the policy and as shown on the ALTA survey;
- Lack of street access;
- Subdivision Map Act violations; and
- Usury.

Zoning endorsements are also frequently requested, although borrowers increasingly resist providing them because of their exorbitant cost. In that event, the lender may seek other reasonable assurances (*e.g.,* certificates of occupancy, zoning letters from the local agency, or legal opinions). In addition, the increasing relevance of mezzanine financing has brought on the development of mezzanine specific endorsements which incorporate "Fairway" and non-importation endorsements. On lenders' policies and these and other lender endorsements, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997). See also Cruz & Rogers, *Commercial Title Endorsements*, 22 Cal Real Prop J 4 (Spring 2004).

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§1.65 2. Hazardous Substances

In the recent past, the presence of hazardous substances on property offered as security could automatically disqualify the property as collateral for a loan. Although this is no longer true, the preparation and review of environmental assessments are absolutely essential to the underwriting of a commercial loan. On most occasions, the least intrusive report, commonly known as a "Phase I," is prepared at the borrower's expense by a consultant approved by the lender. A Phase I assessment typically includes the following:

- A visual inspection of the site, and interviews of onsite property management personnel in order to examine the property's present use, the composition of building materials, and evidence of improper disposal of hazardous waste;
- A search of city, county, state, and federal databases for relevant information on the property and adjacent property for conditions that have (or could have) an effect on the project, such as leaking underground storage tanks; and
- A historical review of the property from available sources, including aerial photographs.

If the Phase I report uncovers any environmental problems, the report generally contains recommendations for methods of further investigation (known as Phase II), such as air sample monitoring (for asbestos) or drilling to ascertain the composition of soils or groundwater. On Phase I and Phase II reports, see California Real Property Sales Transactions, chap 7 (4th ed Cal CEB 2007).

Lender's counsel should confirm that a competent, thorough, and appropriately licensed consultant prepares the report. In addition, environmental consultants often incorporate into their retention agreements unreasonable limitations of liability, sometimes limiting their exposure for a negligently prepared report to the amount of their fee. (If the report is wrong, it's free.) Counsel should reject such a provision and confirm that the consultant has the financial ability or appropriate errors and omissions insurance to satisfy any reasonable liability claim. Counsel should either ensure that the report is assignable to the lender or at least have the consultant acknowledge that the lender will rely on the report.

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§1.66 3. Borrowing Entity

The lender is interested in the borrower's choice of entity because it affects the remedies available to the lender in the event of default, particularly if the loan is made on a recourse basis (see §1.51). Only the persons or entities that sign the promissory note (or a guaranty) will be personally liable for repayment of the loan, subject to any nonrecourse provision in the note (see §1.51) and subject to the one-action, security-first, and antideficiency rules of California law. Thus, to the extent a loan is made on a recourse basis to a borrower composed of one or more individuals, those individuals will be jointly and severally liable for payment of any deficiency on the debt if the lender judicially forecloses. But if the borrower is a corporation or a limited liability company, then only that entity will be liable for repayment of the loan, and the individuals owning the equity in the borrower will generally be shielded from personal liability, no matter what remedy the lender chooses, unless any of those individuals guaranteed the loan. See chap 6 on advantages and pitfalls facing a lender in obtaining guaranties of secured loans. For further discussion of the one-action rule, antideficiency statutes, and guaranties, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5, 9 (4th ed Cal CEB 2009).

Lender's counsel should have a candid discussion with the lender to ascertain its expectations in the event of a loan default and to confirm that the lender understands the impact of California's one-action, security-first, and antideficiency rules. These issues will influence the lender's requirements for the type of borrower entity and credit enhancement, as well as the lender's pursuit of remedies in a default.

In a conduit loan, the rating agencies dictate the type of borrowing entity that may obtain the loan, and neither lender's nor borrower's counsel will have the leverage to vary from that determination. For further discussion of this issue, see §§1.96, 10.7.

Lender's counsel should inquire about the marital status of individual borrowers even if the loan is clearly for commercial purposes. Although borrowers generally may encumber fractional interests in real property, if the real property security for a business loan is held as community property, a nonconsenting spouse may invalidate the lien of a deed of trust *in its entirety* even if it purports to encumber only the community property interest of the borrower spouse. Fam C §§1100, 1102; *Droeger v Friedman, Sloan & Ross* (1991) 54 C3d 26, 283 CR 584.

PRACTICE TIP: To protect itself, the lender may insist on a spousal waiver (confirming that the collateral is the separate property of the signing spouse and waiving any claim to the contrary) or a spousal consent (consenting to, and joining in, the encumbrance of the community property).

If record title is held by the signing spouse alone and the lender proceeds in good faith without knowledge of the marriage, the encumbrance will be presumed valid under Fam C §1102(c)(2) and the other spouse will have only one year after the recordation of the encumbrance to bring an action to attempt to invalidate it. Fam C §1102(d).

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§1.67 E. Concerns of Borrower's Counsel

The negotiating posture of borrower's counsel is inevitably reactive. Unlike purchase and sale agreements, which counsel may prepare for either party (with wholesale changes frequently made by the other party), real estate loan documents are almost always presented on the lender's standard forms. See §1.56. Although requests for changes are not futile, the issues are always framed in the lender's context and concessions are not granted easily. Occasionally, depending on the type of lender and the state of the market, the role of borrower's counsel is largely reduced to a series of cautions to the borrower about its duties under the loan documents (in addition to repayment) and the risks to the borrower on a breach (intentional or unintentional) of those duties.

Borrower's counsel should address the preliminary considerations discussed in §§1.68-1.70 as early as possible in the loan process. For more detailed discussion of negotiating techniques for borrower's counsel, see §§1.72-1.89.

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§1.68 1. Exit Strategy

Although the borrower and the lender focus primarily on procuring and funding the loan, each party should consider the circumstances at the other end of the transaction (*i.e.,* loan payoff or default) to develop an exit strategy.

Typically, a lender has predictable expectations of repayment at maturity or of recovery after loan default (*e.g.,* realization on the security or recourse to other assets through guaranties) that are set forth in the loan documents. Often, however, the borrower fails to fully understand that business considerations might dictate prepayment (see §1.50) or that the lender's exercise of its remedies could result in much more than the loss of the primary security. If interest rates fall substantially during an extended loan term, prepayment fees or charges or prohibitions could put the borrower at a competitive disadvantage, especially if the borrower wishes to sell the property to take advantage of a favorable real estate market. Unless the loan either permits prepayment (with little or no penalty) or is transferable on a sale (*i.e.,* does not include a due-on-sale clause or permits a one-time transfer on payment of a reasonable fee), a sale may be less attractive to the borrower because it would effectively transfer a substantial amount of the borrower's equity to the lender.

Conduit financing has made a huge supply of loan funds available to the borrower at low, fixed-interest rates. In exchange for this benefit, the borrower is locked into the loan for the full term by the prohibition on prepayment. The conduit loan market has attempted to address this golden handcuff aspect of its financing by introducing the concept of "defeasance," which replaces the lender's real property security with United States government securities presumably purchased with refinancing or sale proceeds. For further discussion of defeasance, see §§1.105, 10.21, 3.24A.

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§1.69 2. Borrowing Entity

Although loan commitments frequently permit assignment to the borrower's affiliated entities, counsel should consider the type of business entity (and its domicile) used by the borrower. The choice of business organization involves several tax and operating issues, and state statutes vary in their requirements for internal governance of any particular entity.

Because insulation from liability is often the key concern, counsel should advise the borrower of the evolving nature of nonrecourse loans (see §1.51). Although commercial loans continue to be primarily nonrecourse, the borrower's exculpation is limited, and lenders regularly carve out exceptions for fraud and misrepresentation, waste, environmental matters (typically covered in a separate indemnity), misappropriation of rents, misapplication of insurance and condemnation proceeds, and other matters. Often, unless the borrower has substantial assets in addition to the encumbered real property, the lender requires the personal liability of a creditworthy person or entity (usually, one or more of the ultimate owners of the borrower entity; see chap 5A), or other credit enhancement as a condition of funding the loan. Each requirement effectively undermines the limited liability provided by the borrower's organizational documents.

For discussion of the restrictions on borrower entities imposed by conduit lenders, see §§1.96, 10.14-10.17.

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§1.70 3. Title Issues; Environmental Concerns; Due Diligence

If possible, borrower's counsel should review the condition of title before its client executes the loan commitment. Procuring a preliminary report is relatively quick and inexpensive, and counsel should be confident that the condition of title will be acceptable to the lender before the borrower pays a substantial commitment fee. For a detailed discussion of preliminary reports, see California Title Insurance Practice, chap 5 (2d ed Cal CEB 1997).

In addition, although environmental issues no longer automatically disqualify properties, lenders have justifiable concerns about hazardous materials located on, or in the vicinity of, the prospective security. If the borrower has access to a preexisting environmental report (*e.g.,* a report obtained by the borrower when it acquired the property), borrower's counsel should become familiar with any issues raised in that report. If no such report is available, it may make sense for the borrower to obtain a current Phase I report (from a consultant on the lender's approved list) even before the commitment is signed. Although a Phase I report can be expensive, that cost is usually less than the loan fees the borrower will become obligated to pay on signing the loan commitment, and may alert the borrower to issues likely to concern the lender.

Inevitably, the lender will require the borrower to provide a separate environmental indemnity at the loan closing (see chap 5A; for form, see §5A.12). Often, such indemnities are drafted so broadly as to subject the borrower (and often its principals) to expansive and eternal prospective liability for a host of environmental occurrences. At the outset, borrower's counsel should attempt to insulate, if possible, any individual liability under the indemnity, especially when a "clean" Phase I report has been delivered to the lender and the commercial use of the property is unlikely to present any material environmental risk. Any representation made to the lender about the condition of the property should be subject to the matters disclosed in the environmental reports pre pared as part of the due diligence process. Covenants on hazardous materials should permit the lawful use of products used in the normal course of the borrower's business. The borrower should be permitted to contest any demand for compliance or remediation, or any claim against the property under environmental or hazardous materials laws, if the lender's interests are reasonably protected.

The lender should not require updated environmental audits unless it has reasonable cause to believe that the property is in violation of environmental law. The indemnity should not extend to losses resulting from activities undertaken by the lender or any successor to the lender, including one taking title at a foreclosure sale. Although standard environmental indemnities provide for the survival of the indemnity after the satisfaction of the loan (through payoff or foreclosure), the borrower's provision of a "clean" Phase I report should suffice to terminate the indemnity.

Ideally, counsel should also have a general understanding of the borrower's business and the applicable licenses and permits, leases, franchises, and service contracts affecting the property to be secured.

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§1.71 4. Other Issues of Concern to Borrower

In addition to the issues described in §§1.68-1.70 and the basic economic terms discussed in §§1.74-1.89, other issues of concern to the borrower include the following:

- The borrower's right to a full or partial refund of application and commitment fees and deposits if the loan does not close for any reason beyond the borrower's control;
- The scope of obligations secured by the deed of trust or other security instruments in the lender's favor;
- The reasonableness of costs (including attorney fees) and approval standards for other lender decisions (*e.g.*, sole discretion or reasonable judgment);
- Restrictions on leasing, including the scope of the lender's approval of leases;
- Restrictions on alterations, including scope of the lender's approval of alterations;
- Rights to and application of casualty insurance proceeds (*e.g.*, borrower's right to use proceeds to repair or rebuild damaged property versus lender's right to apply proceeds to pay down the loan);
- Rights to and application of condemnation awards (for both total and partial takings); and
- The borrower's right to contest involuntary liens, property taxes and assessments, alleged violations of the law, and similar matters.

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VII. NEGOTIATING TECHNIQUES

§1.72 A. Commonly Negotiable Terms

In virtually every commercial loan transaction, regardless of the relative bargaining strength of borrower and lender, some loan terms will be subject to negotiation. The terms that are usually negotiable are discussed in §§1.74-1.89.

The most crucial issues to the borrower are best negotiated before the lender issues a loan commitment, and sometimes even before an application is submitted, because most lenders have an institutional (rather than an entrepreneurial) culture. Once the transaction is presented in writing to the lender's credit or investment committee with certain parameters, it is limited by those terms and becomes difficult to change. Further, because the loan documents are almost always prepared by lender's counsel, borrower's counsel is consigned to a responsive posture on any issues not addressed before the loan documents are first drawn. On the importance of counsel's early involvement in the negotiating process, see §§1.54, 2.2.

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§1.73 B. Negotiating Mindset: Basic Goals of Lender and Borrower

A prudent practitioner will look beyond the minutiae of the lender's standard loan documents and take a broad view of the parties' respective desires. As in any business transaction, if the parties view their negotiations as a cooperative venture, with each party considering its own goals in the context of the legitimate goals of the other, solutions often appear. The lender's objective is to have the loan proceeds repaid as scheduled, together with a return on the funds that matches its perception of the risk in making the loan. Because this goal is not always met, the lender wants to have prompt access to adequate real estate security, or other means of recovering the amounts owed (*e.g.,* personal guaranties), to obtain the benefit of its bargain. The borrower's objective is to obtain adequate funding at a reasonable rate and with the least risk (minimal security/credit enhancement), while retaining maximum flexibility in operating and disposing of its property. Each major issue in the loan documents should be negotiated with a view toward satisfying all these objectives. Frequently, they can be met by one or more alternative approaches.

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§1.74 C. Loan Amount

The principal amount of a loan is typically a function of both the net operating income of the encumbered property and the property's market value. Most institutional lenders require that an independent, qualified appraiser, familiar with the type of property offered as security, evaluate the property. Often, the loan commitment states that the proposed loan amount is subject to confirmation by appraisal and, if the amount of the valuation is less than expected, the loan terms may be modified or the principal amount reduced. The lack of an adequate appraisal may even nullify the loan. To avoid this situation, the borrower should have a realistic opinion of the value of its property before paying a commitment fee and deposit against due diligence (including appraisal) expenses.

The debt service coverage ratio (see §1.36) is based on the property's net operating income, and the loan-to-value ratio (see §1.44) is based on the value of the property. As a rule, the required ratios vary among lenders and are affected by property type. Even after the ratios are established and a preliminary loan amount is proposed, that amount can be changed to satisfy both lender and borrower. For example, if the lender disagrees with the appraised value of the property but is otherwise satisfied with debt service coverage, the borrower may consider offering a credit enhancement, such as additional collateral or a personal guaranty, which could be released or canceled, respectively, on the achievement of some future benchmark valuation.

Another approach is to consider the lender's perceived risk and the interest rate necessary to offset that risk. Depending on the type of lender and the market it wishes to serve, the lender may be willing to increase the loan amount in exchange for a higher interest rate. Alternatively, the lender might agree to lower the interest rate during the term of the loan after an objective operating benchmark is reached (*e.g.,* when the property is fully leased).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.75 D. Interest Rate

§1.75 D. Interest Rate

As discussed in §1.74, the interest rate and the loan amount can be negotiated in tandem (within the parameters of the prevailing market) to achieve a mutually agreeable loan transaction. Similarly, the borrower may obtain a lower interest rate if the lender obtains sufficient collateral, some credit enhancement, and perhaps a series of operating covenants that help assure borrower prudence and increase the likelihood of timely loan payments.

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§1.76 1. Fixed Versus Variable Interest Rate

Interest is calculated on either a fixed rate or a variable ("floating") rate. In a convertible loan (see §1.34), the borrower may have the option to convert a floating interest rate to a fixed rate at some time during the term. In choosing a fixed rate, both the lender and the borrower assume interest rate risk in exchange for certainty. Interest rate risk means the risk of a lost opportunity for the lender to lend funds at a higher rate if interest rates rise in the market, or for the borrower to borrow funds at a lower rate if interest rates fall.

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§1.77 2. Advantages and Risks of Variable Rates

A borrower choosing an adjustable interest rate takes the risk that rates will fluctuate during the loan term. If rates rise, the scheduled payments must increase if the principal is to be repaid on time under the agreed amortization (see §1.28). If rates fall, the borrower can reduce its payments while maintaining a steady amortization schedule.

Adjustable rate loans (see §1.27) usually require an immediate change in the next installment payment when the reference rate changes. In a stable interest rate environment, rates could remain unchanged for months or even more than a year. In volatile times, prevailing rates could change more than once a month.

Variable interest rate instruments shield the lender from interest rate risk and permit the borrower to reduce its interest expense (and, usually, its loan payments) in a falling interest environment. The borrower, however, forgoes the ability to predict its debt service expense. Rising interest rates occurring together with falling rents will squeeze the borrower and may put the project at risk. For this reason, borrowers frequently seek a "cap" or a ceiling (maximum rate) on a variable interest rate, and the lender usually requires a "floor" (minimum rate) in return.

Sometimes lenders will require that the borrower procure, at the borrower's cost, an interest rate protection device from a rated financing "intermediary." The intermediary, for a fee, will agree to assume the downside to the borrower's interest rate risk by delivering a "swap" (by which the borrower agrees to pay a fixed interest rate in return for the loan term while the intermediary assumes payment no matter how high the variable rate increase) or a "cap" (by which the intermediary agrees to pay loan interest above a stated level).

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§1.78 E. Amortization

There is no inherent limitation on the parties' ability to structure the loan repayment terms to fit the business plan of the borrower, the expectations of the lender, and the nature of the encumbered real estate. Although loans secured by real property are customarily amortized (with incremental payments of principal, increasing over time, being paid on a regular basis until maturity; see §1.28), there may be opportunities for flexibility if the lender's other concerns are met. For example, in certain circumstances, the lender may permit a limited period of interest-only payments, or even negative amortization (interest accruing under the loan is not fully paid, and the shortfall is added to principal), at the outset of the loan. Typically, the lender will consider such arrangements only if the project's net operating income, although temporarily impaired (*e.g.*, because of renovations to the building, or during a lease-up period), is eventually expected to be sufficient to service a fully performing loan.

To induce a lender to accept an interest-only or negative amortization loan, the borrower should be prepared to provide credit enhancement, on at least a temporary basis, in the form of additional collateral (*e.g.,* a letter of credit) or a guaranty from a creditworthy entity.

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§1.79 F. Maturity Date

Depending on the circumstances, either the borrower or the lender may desire flexibility in selecting a maturity date for the loan. In times of volatile interest rates, the risks associated with a fixed rate affect both parties in a reciprocal fashion (*i.e.,* rates rising after the loan closes benefit the borrower, falling rates benefit the lender). The parties' perception of the future market establishes their willingness to set an earlier or a later maturity date.

The borrower's business plan may dictate its loan term requirements. If the property is just entering the marketplace, the available loan amount is necessarily reduced owing to the lack of operating history and the inherent risks of a new business. The borrower may expect that, after the property is stabilized, it will command a much greater loan amount. If so, the borrower may prefer a short-term loan because a long-term loan would delay its ability to realize the benefit of its increased equity in the project.

Occasionally, the lender may accommodate a conservative borrower's desire for long-term certainty in its capital requirements by granting one or more options to extend the loan after a relatively short initial term. Option provisions favorable to the borrower require only that the borrower not be in default at the time of exercise. Provisions more favorable to the lender require the borrower to satisfy certain underwriting standards and pay additional fees as a condition of exercising the option and to provide a mechanism for adjusting the interest rate for the extended term. When the criteria for extension are complex, borrower's counsel should attempt to ensure that the borrower has every realistic opportunity to exercise the option. The borrower should have the opportunity to cure any disqualifying physical deficiency in the property and, further, to reduce principal (rather than lose the extension altogether) if certain renewal criteria (*e.g.,* loan-to-value or debt service coverage ratios) are not met on the initial maturity date.

If possible, counsel should avoid provisions resetting the interest rate to reflect the "prevailing market," or other subjective criteria. Such imprecise provisions only lead to dispute and negate the value of the option because the borrower could obtain the same terms with any other lender. Moreover, the borrower's objective is to renew its existing financing if suitable alternative financing is unavailable. More certainty is achieved if, when the loan is negotiated, the parties select for the renewal term an index (*e.g.,* LIBOR, Treasury bills; see §1.27) and a spread (*e.g.,* 200 basis points; see §1.29) that are mutually acceptable whether the interest rate for the option period will be fixed or floating. This strategy should be used with caution, however, because the spread applicable to specific property types varies with real estate cycles.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.80 G. Grace Periods

§1.80 G. Grace Periods

In the past, almost all loan payments were made by check and delivered by mail. Because occasional delays were expected, lenders usually granted borrowers a reasonable period of time after the stated due date during which payments could be received without penalty. Today, alternative payment arrangements that do not rely on the mail (*e.g.,* wire and electronic funds transfers, or automatic debits from other borrower accounts with lender) are increasingly common. Nonetheless, borrowers continue to request, and lenders usually permit, grace periods of up to 15 days (more often 5 to 10 days), before a late charge or default interest is imposed. Because the borrower may be unaware that the lender has not received a payment due to a failure in the delivery mechanism, borrowers sometimes prevail on the lender to give notice before the grace period runs, but this is not common.

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§1.81 H. Notice and Cure Periods

Lenders rarely agree to extend the grace period (see §§1.38, 1.80) for scheduled loan payments. Borrowers usually have more success in obtaining the right to receive notice of, and the opportunity to cure, a breach of a nonmonetary covenant in the loan documents. As discussed in §1.80, the borrower already has the opportunity to "cure" payment defaults during the grace period. In addition, whether certain other loan covenants have been violated, and to what extent the borrower must redress the violation, are often harder to ascertain than whether specific loan payments were made.

EXAMPLE: The timely payment of real estate taxes or insurance premiums is easy to establish, but whether the property is being properly maintained, or whether financial reporting requirements are being met, is more subjective.

Requiring the lender to notify the borrower of defects in performance gives the borrower a chance to address (or dispute) the lender's demand and gives the parties an opportunity to establish a dialogue before the lender imposes sanctions or exercises its remedies.

Typically, the borrower's right to cure requires the borrower to promptly take steps to address the problem. Usually, the main issue for negotiation is the proper time period to accomplish the cure. Borrower's counsel usually seeks "a reasonable time" because that phrase enables a flexible approach. Lender's counsel, however, may seek a more certain time (*e.g.,* 30 days), and may also require that the borrower diligently proceed to cure in all events.

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§1.82 I. Credit Enhancement

As discussed in §§1.74-1.79, the perceived risk to the lender, interest rate, loan amount, and security are interrelated: an adjustment in one requires or justifies an adjustment in another. In certain circumstances, a loan would not be made at all without some credit enhancement (see §1.59). For example, construction loans are virtually always recourse to the borrower (see §1.51) or require a personal guaranty from a creditworthy principal of the borrower.

If the lender is reluctant to make a loan without credit enhancement, borrower's counsel and lender's counsel should advise their clients of the relative risks and benefits of the various types of credit enhancement. Common forms of credit enhancement include full or partial payment guaranties, carry guaranties, letters of credit, and collateral interests in deposit accounts or additional real property. "Springing" or "exploding" guaranties (see §1.39) are designed to secure the borrower's obligations under exceptions to the exculpation provisions in the loan documents (usually relating to borrower behavior) and are not considered credit enhancement. For a detailed discussion of guaranties, see chap 6.

Counsel should be alert to the opportunities for negotiation presented when the borrower provides additional assurances to the lender about repayment. Frequently, these devices are somewhat interchangeable and need not exist for the life of the loan.

EXAMPLE: A letter of credit intended to secure the borrower's obligation to fund operating shortfalls after completion of renovations may be allowed to expire once the project shows an adequate debt service coverage ratio (see §1.36) for 12 months.

In variable rate loans, borrowers sometimes wish (or are required) to protect themselves (and the lender) from the risk of rising rates by purchasing an interest rate "swap" or an interest rate "cap." In a swap, the borrower trades the obligation to pay the variable rate with a creditworthy third party and assumes that party's obligation to pay a fixed rate for the same principal amount. An interest cap (purchased from a third party financial institution) indemnifies the borrower to the extent the interest rate under the borrower's loan exceeds a certain agreed maximum.

The creation, execution, and implementation of guaranties, letters of credit, and security interests in additional collateral give rise to other legal issues that are beyond the scope of this chapter. For discussion of security interests in personal property collateral, see chap 7.

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§1.83 J. Personal Liability: Exceptions to Nonrecourse Provisions

Traditionally, the only exceptions to nonrecourse provisions were based on common law tort theories (*e.g.,* bad faith waste or fraud in the inception). Over the years, lenders have learned that the value of the security can be seriously compromised by matters that are outside the lender's control but that are usually, but not always, within the borrower's control. As a result, lenders have increasingly carved out exceptions to the borrower's exculpation to impose personal liability for certain acts or events, sometimes to the extent that personal liability lies in almost all circumstances (subject to antideficiency limitations). On California's antideficiency rules, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5 (4th ed Cal CEB 2009).

Borrower's counsel should attempt to limit these exceptions to borrower misbehavior (*e.g.,* misappropriating funds). Borrower's counsel should also resist any attempt by the lender to convert the entire principal to recourse for technical violations that are subsequently cured or when the harm suffered by the lender can be reasonably quantified (*e.g.,* costs incurred by the lender to repair the property to the standard required under the loan documents). The borrower should also be relieved of all recourse liability if the loan is assumed by a third party in accordance with the loan documents.

The key concerns of lender's counsel are the following:

- Nothing in the exculpation provisions would act to limit the lender's exercise of its remedies;
- The lender is entitled to full recovery on any losses from the borrower's diversion of operating revenues after default or from the borrower's filing bankruptcy proceedings to delay foreclosure;
- The borrower is liable for the lender's attorney fees and costs incurred in enforcing nonrecourse carve-outs; and
- Most important, with a single-asset borrower, a financially responsible entity or individual indemnifies the lender for these liabilities.

Additional lender concerns are environmental hazards (which may be serious enough to justify the lender's abandonment of the security); the borrower's failure to pay property taxes and insurance premiums; and impermissible transfers of, or junior encumbrances on, the property. Frequently, the obligations to satisfy lender losses despite the lender's realization on the security are "springing" (*i.e.,* they arise as a result of an event, such as the borrower's bankruptcy filing) and can expose the borrower (or a third party indemnitor, usually a principal of the borrower) to liability for a specific loss or for the full amount of the debt.

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§1.84 K. Due-on-Sale (Transfer of Interests in the Property)

Due-on-sale clauses are generally fully enforceable according to their terms under the Garn-St. Germain Depository Institutions Act of 1982 (Pub L 97-320, 96 Stat 1469), known as the Garn Act. Garn Act §341(b)(1). Blanket prohibitions against transfers of interests in the real property security (or interests in the borrower entity, see §1.85) to a new owner are common in lenders' standard forms. Borrower's counsel should carefully review these restrictions with the borrower and discuss the borrower's short- and long-term goals for the property. If the borrower can neither prepay the loan without an exorbitant penalty nor transfer the property, the borrower will be unable to realize its equity before the loan matures.

Because even the most carefully thought-out business plans are not always realized, borrower's counsel should request an exception to the due-on-sale provisions for a bona fide sale to an experienced, creditworthy borrower, at least on a one-time-only basis during the loan term. If granted, these provisions almost always require the borrower or the proposed new owner to pay a transfer fee (usually about 1 percent of the outstanding balance of the loan) and the lender's underwriting expenses. The loan documents should specify the new owner's required qualifications and should require the lender to be prompt and reasonable in evaluating a proposed buyer's acceptability as a substitute borrower.

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§1.85 L. Transfers of Interests in Borrower

Standard loan documents typically include in the definition of a prohibited "transfer" any significant transfers of ownership interests in the original borrower. Borrower's counsel should carefully review these restrictions with the borrower and discuss the need for flexibility in making any changes in ownership.

At a minimum, counsel should request, and the lender should accept, modifications that permit internal transfers of interests in the borrower among principals and transfers for estate planning purposes. Lenders tend to resist permitting transfers of interests to third parties because loan underwriting relies in part on the expertise and financial standing of certain individual principals of the borrower. If those principals continue to hold substantial equity, however, transfers of interests to outsiders that do not result in a change of management and control might be acceptable.

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§1.86 M. Prepayment

Because a borrower may wish to voluntarily prepay its obligation (*e.g.,* if the borrower desires to sell the property before loan maturity, or to refinance it to pull out equity or obtain a lower interest rate), borrower's counsel should expressly address prepayment in the earliest negotiations and attempt to include a prepayment right in both the loan commitment and the promissory note. The lender, however, may want to control the borrower's right to prepay in order to increase the predictability of its investment return.

Prepayment rights may be conditioned on the borrower's payment of a fee or "premium." The calculation of the prepayment premium is generally a business issue over which counsel has limited control. Borrower's counsel, however, should strive to accomplish at least the following goals:

- There should be a reasonable period at the end of the loan term (at least the last 30-90 days) during which the loan can be paid without penalty;
- The prepayment premium should not apply if principal is reduced by the lender's application of insurance or condemnation proceeds;
- The prepayment premium should not apply when the borrower is required to pay down principal to maintain required loan-to-value (see §1.44) or debt service coverage ratios (see §1.36); and
- If the lender insists on the right to enforce the due-on-sale clause at its sole discretion and insists that it need not consider any purchaser of the security as a substitute borrower, counsel should attempt to have the premium on the resulting prepayment waived on the basis that the lender is the ultimate decisionmaker on prepayment.

As discussed in §1.104, the two most common methods of calculating prepayment premiums are a percentage of the prepaid amount and the yield maintenance formula. The yield maintenance premium is a lump-sum payment that represents the discounted value of a revenue stream at the loan rate less the discounted value of a revenue stream calculated at the then-prevailing interest rate for reinvestment of the prepaid principal. The negotiations usually focus on which rate to use for the proper return on the reinvested proceeds (*e.g.,* prime rate, Treasury bills, market rates for similar loans), and which rate to use for the discount rate.

Because market rates for real estate loans always exceed Treasury bill rates (because of the increased risk posed by real estate), and portfolio lenders would not reinvest in government securities (because the return is too low), the borrower may argue that the lender's losses should be measured by the prevailing rate for real estate loans. The lender may argue that it should not be forced to search for another lending opportunity simply because the borrower has chosen to prepay the loan. Because the spread between a given index rate and loan rate is frequently over 200 basis points (see §1.29), it is worthwhile for the borrower to seek some accommodation from the lender (*e.g.,* setting the reinvestment rate at 75 to 100 basis points over Treasury bill rates). Certain conduit lenders, who are prohibited from making new loans with prepaid principal, will invariably require that yield maintenance be based on government securities because that is where the funds will actually be reinvested. On prepayment restrictions in conduit loans, see §§1.102-1.105, 10.21.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.87 N. Operating Covenants

§1.87 N. Operating Covenants

Although borrowers prefer to have no postclosing obligations other than making scheduled debt service payments, lenders routinely request several operating covenants that require or prohibit certain actions by a borrower during the term of the loan. Even if the borrower continues to make scheduled payments, if the project's operating cash is insufficient to pay all its cash expenses, the lender may have to categorize the loan as "at risk"; otherwise, a rating agency may lower its rating on the applicable mortgage-backed securities pool. Operating covenants are sometimes required by the governmental entities or bond rating agencies that oversee the lender.

The most common operating covenants require the borrower to

- comply with all governmental laws and regulations;
- maintain the real property security in accordance with stated standards;
- timely pay all real estate taxes and assessments (which are senior to any deed of trust);
- timely pay all hazard and liability insurance premiums;
- set aside reasonable reserves for tenant improvements or capital replacement; and
- provide the lender with financial information (at a minimum, a balance sheet and an operating statement) on a regular basis.

On the use of impound accounts to pay taxes and insurance premiums and reserve accounts for tenant improvements, see §§1.88 and 1.89 respectively.

PRACTICE TIP: To the extent possible, the borrower wants reporting requirements to be consistent with those already in place (*e.g.,* the reporting requirements imposed on the general partner, managing member, or manager of the ownership entity in the organizational documents). In particular, the borrower should make sure that:

- The timing requirements for delivery of financial information are reasonable (*e.g.,* within a manageable period after the applicable quarter or year);
- Audited statements are required no more often than the borrower would otherwise obtain such statements (although the lender may be unwilling to compromise on this point); and
- Reports are prepared in accordance with "standard accounting practices" as opposed to the more rigid accrual-based "generally accepted accounting principles" (although, again, there may be little room for negotiation).

PRACTICE TIP: To the extent any financial statement must be certified, the borrower should consider who must make the certification and whether it can be limited to facts within the borrower's knowledge.

Lenders occasionally require the borrower to obtain the lender's consent before taking certain actions regarding the property, such as executing leases or making improvements. Borrower's counsel should attempt to eliminate these requirements or limit them to circumstances outside the borrower's normal course of business. Lender's counsel should point out that, if the lender takes too large a role in controlling the borrower's business affairs, a failing borrower may assert a claim under lender liability theories. In any event, if lender consents are required, they should not be unreasonably withheld, conditioned, or delayed. Another covenant that the borrower should vigorously resist provides that, if the lender deems itself "insecure," the borrower must deliver additional collateral or risk acceleration of the loan. At a minimum, the borrower should try to establish objective criteria for the lender to consider itself "insecure." For a general discussion of lender liability issues, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 12 (4th ed Cal CEB 2009).

On one hand, borrower's counsel should welcome provisions that reward the borrower for meeting a certain operating benchmark, *e.g.*, by lowering the interest rate on achievement of a more favorable debt service coverage ratio, or canceling a partner's guaranty of the debt on the stabilized lease-up of the project. On the other hand, borrower's counsel should resist to the fullest extent possible any provision that allows the lender to accelerate the loan if a financial operating covenant is breached. Instead, the borrower should be permitted to "cure" the default by posting

additional collateral or paying down the principal balance of the loan.

Operating covenants should be analyzed carefully and discussed with the borrower to see whether they can reasonably be met in the normal course of operations and in an economic downturn.

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§1.88 O. Impound Accounts

Impound accounts are a form of credit enhancement because they reduce the lender's exposure if the borrower fails to make timely payments of certain operating expenses of the encumbered property. Typically, impounds are established to pay real property taxes and insurance premiums, two expenses that pose the greatest risk to a lender: A lien for unpaid property taxes has priority over the lender's deed of trust, and the loss of hazard insurance coverage for the property could be catastrophic. In the past, impounds were used only when the lender faced an increased risk that these expenses would not be timely paid or that the real property would be insufficient to satisfy the debt on default. For example, if the loan was made with aggressive debt service coverage (see §1.36) or loan-to-value ratios (see §1.44), the lender would require impounds to provide simultaneously for a sinking fund for future cash outlays and for additional cash collateral.

Lenders value impound accounts even though the additional security is limited to the impound account balances at any given time. Impounds are usually deposited in a general account and generate interest for the lender, which is not passed on to the borrower. Thus, impounds provide an additional benefit to the lender by incrementally enhancing its yield. In the age of conduit lending, using impounds for real estate taxes and hazard insurance premiums is popular as a reasonable method of assuring uninterrupted cash flow to the lender, which helps maintain favorable ratings for its loans. Many borrowers resist impound accounts, but they can be helpful to a borrower with uneven cash flow.

PRACTICE TIP: Impounds may sometimes be negotiated away with a portfolio lender (see §1.18), or at least limited to circumstances in which the loan is in default or at measurable risk of default, but rarely, if ever, in a conduit loan. See further discussion in §§1.97, 10.13.

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§1.89 P. Reserves

Similar to impounds, the concept of capital replacement or tenant improvement reserves addresses the fact that certain substantial expenses are irregularly incurred in the operation of a real property asset. In retail or office projects, the rental stream varies as tenants come and go, and the vacant space may have to be reconfigured for a new tenant at substantial expense. Depending on the amount of space involved and the state of the rental market, a landlord may provide a tenant improvement allowance based on a "building standard" improvement per square foot. Although tenant improvement allowances (like leasing commissions) are generally recovered over the lease term as part of rental receipts, a reserve required under the loan documents provides a cash fund for defraying these up-front, out-of-pocket expenses.

Multifamily residential, hotel, and restaurant properties also require periodic updating of equipment and structures that are worn out, obsolete, or have otherwise reached the end of their useful lives. This requirement is especially important in the hospitality business because recovering from a "tired" reputation can be difficult, if not impossible. In these businesses, lenders frequently require that a certain percentage (usually from 1 to 5 percent) of the gross revenue from the asset be set aside for capital replacement reserves.

Unlike impounds, however, lenders are usually more flexible in establishing, maintaining, and disbursing these reserve accounts. Occasionally, the lender will permit the borrower to establish reserve accounts in its own name and simply provide the lender with a security interest in them, which gives the borrower greater control over the account, including the right to earn interest. The issues of concern generally relate to the following:

- The dollar amount of the reserves;
- The scope of the expenses that the reserve may be used to defray;
- The process of review and approval by the lender; and
- Whether the borrower must pay the expenses first and seek reimbursement, or whether the fund may be used to pay expenses as they arise.

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VIII. CONDUIT FINANCING; A SUMMARY

§1.90 A. Wall Street Comes to a Bank Near You

Commencing in the early 1990s and continuing at an accelerating pace through the early and mid-2000s, another source of funding for commercial transactions became available: Wall Street. Though not a direct lender, the investment banking houses (with the participation of mortgage lenders, real estate professionals, and the real estate bar) developed a process by which pools of loans were originated, purchased, packaged, and resold as investment vehicles similar to a corporate bond. The ultimate source for funding the individual loan was not the originating lender, which acted primarily as a conduit for the delivery of the funds; hence the term "conduit loan" (see §§1.18, 1.33). The investment vehicles, generally known as commercial mortgage-backed securities (CMBS; see §1.33), were offered by any number of entities, including real estate mortgage investment conduits (REMICs) (see §3.24A).

This methodology for providing greater access to capital for commercial properties was not really novel. Home mortgages had been packaged and purchased under the auspices of the Federal National Mortgage Association (FNMA) for decades. Unlike single-family dwellings or condominiums, which are generally occupied by the owner/borrower and share a common property type and loan amount range, investment pools of commercial loans cover a wide range of property types, ownership, and loan amounts. For further discussion, see §§10.1-10.5.

WARNING: With the devastating downturn in the financial markets beginning in 2008, the CMBS market came to a screeching halt. The result has been that lenders are loathe to lend, while some have folded or been absorbed by others in the field. The next few years will determine if, and how, this market will survive.

The following sections (§§1.91-1.107) summarize conduit financing characteristics and requirements. For full discussion and sample form clauses, see chap 10.

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§1.91 B. Advantages of Conduit Financing

Conduit financing greatly expanded the pool of accessible capital for commercial loans. Money that would otherwise be invested in traditional debt instruments, such as corporate bonds and Treasury bills, became available for investment in CMBS. In addition, life insurance companies, which have always included a substantial real estate loan component in their investment portfolios, have increasingly invested in pools of diversified commercial loans rather than individual loans underwritten, originated, and serviced by the life insurance company itself. This increase in the source for loan funds nationwide (and to some degree worldwide) resulted in a mitigation of capital shortages, and a rush of investors and borrowers to participate in the emerging market.

The increase in the supply of loan funds tends to drive interest rates lower, which provided additional benefit to the borrower. Also, conduit loans generally have a fixed interest rate, providing the borrower a degree of certainty in the future interest costs of its property. The interest rate is set by the market's perception of the risk at the time the loan is funded. Typically, the loan originator is unconcerned with the interest rate risk (see §1.76) because it does not retain the loan in its portfolio. Instead, the risk is shifted to those who purchase and sell the CMBS in the financial markets.

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§1.92 C. Disadvantages of Conduit Financing

The primary disadvantage to the borrower of conduit financing is the lack of flexibility in a financing product that is packaged for wide marketability. The loan documents greatly restrict the borrower and are largely nonnegotiable. Additional costs are involved to the extent that the borrower must adapt its governing documents and business operations to fit the conduit model of a single-purpose, bankruptcy-remote entity (see §1.96). Prepayment of the loan is either prohibited or cost-prohibitive, limiting the borrower's ability to sell or refinance its property during the term of the loan. The borrower has nothing like its traditional, personal relationship with its neighborhood lender, which is helpful when circumstances change or a workout is in order (see §1.43).

EXAMPLE: The loan master servicer generally has little incentive to cooperate with a borrower's postclosing requests to modify the loan documents to take into account any change in circumstances. In addition, if the lender is a REMIC (see §1.90 for definition), it may not be able (without adverse tax consequences) to amend the loan documents to provide for defeasance rights not contained in the original loan documents (see Treas Reg §1.860G-2(a)(8)), and it may also be difficult to make other material changes to the loan documents that the borrower might otherwise assume would be uncontroversial. See Treas Reg §1.860G-2(b)(1). Although there are some exceptions (*e.g.,* when the loan is in default) under the tax laws allowing for amendments (Treas Reg §1.860G-2(c)(3)), other constraints in the pooling and servicing agreement may severely limit the range of permitted modifications. This may not seem significant now, but it will be interesting to see how different the first few conduit loan workouts are. See Murray, *Workouts in the Twenty-First Century*, 17 Cal Real Prop J 1 (Fall 1999).

NOTE: Instability in the CMBS market proved to have a destabilizing effect on both the real estate and financial markets beginning in early 2008. (See chap 10 for discussion of the reasons for the instability.) The 2009 bankruptcy filing by General Growth Properties, owner of more than 200 shopping malls and the single largest CMBS borrower in the United States, may only be the tip of the iceberg. In addition to the parent company, the bankruptcy involves 166 separate, single-purpose, supposedly bankruptcy-remote entities (see §1.96, chap 10). See Hudson & Wei, *Move by General Growth Rattles Malls' Investors,* Wall Street Journal, May 8, 2009 (which can be found on the Wall Street Journal website listed in the Directory).

Borrower's counsel may find it useful to become acquainted with the statutory and contractual framework governing CMBS loans. See Loubier, *Securitized Commercial Mortgage Loans, Modifications and Workouts,* 22 Cal Real Prop J 31 (Winter 2004). On workouts of problem loans generally, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 10 (4th ed Cal CEB 2009).

For further discussion of the lender controls and restrictions imposed on conduit borrowers, see §§1.95-1.107, 10.6-10.23.

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§1.93 D. Role of Rating Agencies

Until recently, business (and sometimes legal) issues were subject to the policies and review of a portfolio lender's credit committee. In the age of conduit loans, the ultimate arbiters of a loan transaction's strengths and weaknesses are the credit rating agencies that review the loan pool in which the loan is packaged. See §10.7. Loans are subject to a "stress test" in which attributes of the security and the loan are evaluated. The less risk posed by the loan pool, the higher the credit rating bestowed on the pool, and the higher the price (and the lower the yield) of the securities backing the loan pool. The more "moving parts" in the loan transaction, the more difficult it is for a rating agency to assess inherent risks. Accordingly, to decrease the number of "moving parts," originators of conduit loans are generally reluctant to accommodate deviations from standardized loan documentation. Certain requirements, such as the use of single-purpose, bankruptcy-remote borrowing entities (see §§1.96, 10.14-10.17), are mandatory.

Standard representations and warranties are also required of the borrower (as well as the originator and each additional party having an interest in bringing the loan to the securities market). Because a thorough due diligence review of each loan is cost-prohibitive, the representations and warranties are used as a partial substitute for traditional underwriting, and they are treated seriously. If the manager of the pool discovers that any of these representations and warranties is false (typically after default, when the loan file and the property are analyzed in depth), the pool generally has the right to force the originator of the loan to repurchase it from the pool.

NOTE: With the downturn in the economic markets in the late 2000s, rating agencies have come under increasing criticism for laxity in rating individual and pools of loans. Litigation over these claims will likely increase over the near term. See chap 10 for additional discussion.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.94 E. Threshold Requirements

§1.94 E. Threshold Requirements

Three fundamental principles must be assured before a conduit loan is made:

- Uninterrupted payments of scheduled debt service (see §§1.95-1.101);
- No prepayment of principal before the scheduled maturity date (see §§1.102-1.105); and
- Timely principal repayment on the maturity date (see §§1.106-1.107).

These concerns are satisfied by implementing the various techniques discussed in §§1.95-1.107.

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§1.95 1. Uninterrupted Cash Flow to Lender

The commercial mortgage-backed security is designed to perform exactly like a low-risk bond obligation. The investor puts its money in, gets a regular, fixed return, and then gets its money back. Anything that would interfere with that arrangement is excised from the transaction to the extent possible.

To ensure a steady cash flow to the lender, a conduit loan may impose all or any combination of the requirements discussed in §§1.96-1.101.

NOTE: A severe downturn in the economy, as occurred in 2008-2009, disturbs the anticipated "uninterrupted cash flow" on commercial properties as vacancy rates rise and rental income drops. As defaults on the loans underlying a CMBS increase and investors become dissatisfied with their returns, the price of these bond-like obligations drops.

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§1.96 a. Single-Purpose, Bankruptcy-Remote Borrower Entity

In virtually all conduit loans, the borrower's business purpose must be limited solely to the ownership and operation of the real estate that secures the loan. The borrower must organize as (or amend its governing documents to convert to) a so-called "single-purpose" or "special-purpose" entity (SPE) or "single purpose vehicle" (SPV). If the borrower is an existing entity, it must amend its governing documents to prohibit acquiring additional properties or undertaking other business enterprises. The purpose of this requirement is to isolate the borrower from unrelated activities that could impair the free and direct flow of revenues from the project to the lender. Thus, the financial difficulties of other real estate projects (or the core business of an affiliate of the borrower, in the case of an owner-user) will not compromise revenues of an otherwise successful enterprise.

WARNING: Forming a single-purpose entity may involve numerous costs, including transfer taxes and a property tax reassessment resulting from any required (nonexempt) transfer of real property or change in ownership. In California, a transfer to a single-member limited liability company (wholly owned by the transferor) should be exempt from both reassessment (Rev & T C §62(a)(2)) and transfer taxes (Rev & T C §11925(d)). See also Rev & T C §11911(a), which imposes the transfer tax on a document by which "realty [is] *sold*" (emphasis added), and 82 Ops Cal Atty Gen 56 (1999), concerning a transfer to a wholly owned corporation. The new entity, however, may be subject to California's annual minimum franchise tax (Rev & T C §§17941, 23153(d)) and an annual gross-receipts fee, which is subject to annual adjustment by the Franchise Tax Board (Rev & T C §17941).

Conduit lenders also require that the borrower's governing documents make it as "bankruptcy remote" as possible. Changes made in 1994 and 2005 to federal bankruptcy laws (11 USC §§101(51B), 362(d)(3)) have reduced the opportunities available to a single-asset debtor-in-possession to extract favorable results (*e.g.,* using protracted bankruptcy proceedings, under which the lender obtains little or no debt service, as leverage in workout negotiations). Nonetheless, lenders continue to limit the borrower's access to bankruptcy remedies to the extent feasible.

EXAMPLE: The lender may require that the borrower's governing documents require the unanimous consent of all equity holders in the borrower before a bankruptcy filing, and for a corporate general partner or managing member, require the corporation to have an "independent" director whose consent is required to commence a bankruptcy case. See Hudson & Wei, *Move by General Growth Rattles Malls' Investors,* Wall Street Journal, May 8, 2009 (which can be found on the Wall Street Journal website listed in the Directory), for a description of how a CMBS borrower was able to file bankruptcy for 166 supposedly single-purpose, bankruptcy-remote entities.

Lenders also wish to insulate the borrower from the effects of bankruptcy proceedings involving the borrower's affiliated entities. To this end, conduit lenders require that the borrower take certain steps to ensure that its operations are sufficiently independent of other operating entities controlled by the same individuals, such as parent or sister companies. For further discussion, see §§10.14-10.17.

Further, lenders occasionally request borrower's counsel to issue a nonconsolidation opinion, assuring the lender that the borrower's assets will not be subject to a bankruptcy case involving an affiliate. Owing to the factual basis and prospective nature of such an opinion, counsel should resist this request or be very cautious in complying with it. For further discussion of legal opinions, see chap 8.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.97 b. Impound and Reserve Accounts

§1.97 b. Impound and Reserve Accounts

The borrower must establish and maintain impound accounts to pay property taxes and insurance premiums and, frequently, replacement reserves for capital replacement or tenant improvements. These accounts impose discipline on the borrower to properly provide for these recurring property expenses, thus enhancing the prospects for uninterrupted cash flow to the lender. The funds also serve as additional collateral for the lender on borrower default. For a discussion of negotiating techniques regarding impound and reserve accounts, see §§1.88-1.89.

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§1.98 c. Lock Box System

In a "lock box" system (see §1.45), the borrower's operating receipts are swept into a bank account controlled by the lender. These funds are then applied first to loan payments and other property expenses (such as impounds and reserves) before remaining funds are made available to the borrower. Lock boxes have become a standard feature on large property and operational loans.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/1 Introduction to Real Property Financing and Negotiating Techniques/§1.99 d. Operating Covenants

§1.99 d. Operating Covenants

Conduit lenders may require certain operating covenants, such as the use of a standard lease form, or that rents comply with an approved rent schedule. Sometimes the lender may even insist that it approve (or have the ability to remove and replace in certain circumstances) the property's management company.

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§1.100 e. No Subordinate Debt

The conduit lender wants to keep the borrower interested in the property's prospects during the entire loan term; therefore, subordinate (or junior) financing that allows the borrower to realize more of its equity (or increases the borrower's return on remaining equity) is generally prohibited. Inherent conflicts between senior and junior lienholders in a workout or foreclosure situation also make conduit lenders (always first lienholders) reluctant to accept additional secured debt. Nonetheless, lenders occasionally permit subordinate financing in order to improve the security. Because any additional debt service reduces the debt service coverage ratio (see §1.36), and thus the senior lender's cushion, subordinate financing is likely to be allowed only when all proceeds are denoted to improvements that are expected to significantly improve the market value or operating cash flow of the property (or both), and when a subordination agreement acceptable to the conduit lender is executed by the junior lender. For further discussion, see §10.19.

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§1.101 f. Credit Enhancement

Credit enhancement devices, such as additional real property collateral, letters of credit, guaranties, and holdbacks or reserves, provide additional assurances that the lender will be repaid in full and on time (see §1.59). To the extent that the lender's recovery may be delayed (*e.g.,* pending enforcement of a guaranty, or foreclosure on other collateral), some of these devices are less valuable than others in achieving continuous cash flow to the holder of the debt. For further discussion, see §10.18.

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§1.102 2. Prepayment Restrictions

In exchange for the lowest fixed interest rate available when the loan is made, the borrower must pay that rate for the full term of the loan until the maturity date, even if interest rates fall during the term. Again, the conduit loan functions like a bond. If the borrower pays off the loan prematurely in a market of lower interest rates, the lender's reinvestment of the proceeds will not provide the expected return. Thus, prepayment of conduit loans is either prohibited entirely (see §1.103), severely penalized (see §1.104), or permitted only by "defeasance" (see §§1.105, 10.21). On prepayment generally, see §§3.22-3.34.

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§1.103 a. Prohibition of Prepayment

The simplest way for the lender to avoid prepayment is simply to prohibit it. That approach is used on occasion, but it does not take into account the realities of commercial real estate. More often, prepayment is prohibited during the first year or two of the loan (sometimes longer), which is known as the "lock-out period." The lock-out period reflects the amount of time the originator expects it will take for the loan to be packaged with other commercial loans and for interests in that pool to be sold, *i.e.,* "securitization." For further discussion, see §10.21.

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§1.104 b. Prepayment Premium

After the lock-out period expires (see §1.103), prepayment is usually permitted for a fee or "premium." The prepayment premium is based either on a certain percentage of the amount prepaid, which may diminish over time (*e.g.,* 5 percent in year three; 4 percent in year four, etc.), or on a yield maintenance formula, which results in a lump-sum payment intended to compensate for the lender's diminished return when it reinvests the funds in a lower interest rate environment. The latter type of prepayment premium effectively transfers to the lender any savings that the borrower would realize by refinancing at a lower interest rate. A large prepayment premium can cause other problems for a borrower by increasing the borrower's cost of selling the property, thus reducing the borrower's return on sale.

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§1.105 c. Defeasance

Because certain CMBS (see §1.18) vehicles are prohibited from reinvesting prepayment proceeds, another prepayment device was developed that permits a sale or refinancing of the encumbered property without paying off the loan. "Defeasance" is the term used to describe a method by which the original real estate security is released and replaced with substitute collateral to secure the debt. Because the original loan remains in place, there is no prepayment. See also §3.24A.

The required substitute collateral almost always consists of Treasury bills. The yield realized by the lender on the substitute collateral must equal the interest rate fixed under the original loan. As a rule, the face amount of the purchased Treasury bills exceeds the "prepaid" principal because the yield on Treasury bills (a virtually risk-free instrument) at the time of the sale or refinance is typically lower than the fixed rate under the original loan (which likely contained a spread over Treasury bill rates or some other interest rate index at the time the loan was made). Ordinarily, the borrower must purchase a number of Treasury bills, with amounts and maturities tracking scheduled debt service installments as closely as possible, to make funds available for amortization of principal.

When defeasance is implemented in connection with a refinancing (as opposed to a sale) of the borrower's property, the borrower in essence has two loans: the original, which should be self-servicing (because it will be paid from the proceeds of the purchased Treasury bills), and the new refinance obligation, which may be a traditional real estate loan. If the property is sold rather than refinanced, there is only one loan, but the borrowing entity cannot be dissolved until the conduit loan's original maturity date. Other requirements for defeasance include indemnities, opinions of counsel (that the device will work, without adverse tax consequences to the lender), and the actual arrangements for servicing the original loan.

For further discussion and sample form clauses, see §§10.21, 10.30.

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§1.106 3. Assuring Repayment at Maturity

The goal of the conduit loan is to mirror a bond instrument: regular payments of debt service followed by timely repayment of principal at maturity. Although absolute assurance of repayment at maturity cannot be achieved at the inception of the loan, methods have been developed to mitigate the risk that the loan will not be paid at maturity. One method, known as hyperamortization or the prepackaged workout, is discussed in §§1.107, 10.21. The second method, which is often standard procedure for lenders, uses a lock box system (see §§1.45, 1.98) to service the loan and retire principal.

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§1.107 4. Hyperamortization: The Prepackaged Workout

In the hyperamortization approach, the loan's stated maturity date is set at the end of the amortization period (20 to 30 years) while the parties agree to an anticipated or optional maturity date (usually 5 to 10 years) that more accurately reflects when the parties expect the loan to be replaced. If the borrower cannot refinance the loan at the earlier date, the parties negotiate at the inception of the loan the details of an acceptable workout of the loan (known as a prepackaged workout). A typical provision increases the loan's fixed rate to 200 basis points (see §1.29) above the initial rate (or some other spread above the prevailing Treasury rate for an obligation having a maturity matching the amortization period). Even if the increased interest rate results in operating shortfalls, the loan is characterized as performing because any interest payment shortfalls are accrued, capitalized (interest accrues on the capitalized interest), and become due on acceleration because of default, refinancing, or ultimate maturity. For further discussion and a sample form clause, see §§10.21, 10.31.

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The Loan Commitment

M. J. Pritchett
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§2.1 I. ROLE OF THE LOAN COMMITMENT

The attorney's work on a commercial real estate loan usually begins with a loan commitment.

Sometimes the attorney may be called on to draft, or to review and comment on, the loan commitment. In other cases, the lender and borrower will have already executed the commitment, and the attorney's job will be to prepare or review the loan documents in accordance with the terms of the commitment. In either event, the loan commitment is an essential point of reference in the negotiation and preparation of loan documents.

Broadly speaking, a loan commitment is a written agreement under which either the lender or the borrower becomes obligated to negotiate or consummate a commercial real estate loan transaction. These agreements take a variety of forms and may be referred to (more or less accurately) as a loan commitment, a term sheet, a loan application, or a commitment letter.

The three main functions of a loan commitment are the following:

- To set forth the major loan terms to which the parties have agreed;
- To provide a checklist of closing conditions that the borrower must satisfy to obtain the loan; and
- To set forth the parties' legal obligations to each other until the time the loan is made.

Loan commitments are usually evidenced by a writing; in fact, the statute of frauds requires that a commitment by an institutional lender to make a commercial real estate loan in excess of $100,000 be in writing. CC §1624(a)(7).

A loan commitment is generally viewed as benefiting the borrower. By assuring the borrower of the availability of financing, it may allow the borrower to proceed with other elements of a transaction. For example, the existence of a permanent loan commitment might enable a borrower to obtain construction financing. Similarly, a loan commitment could permit a borrower to obtain equity financing or to waive a financing contingency in a purchase agreement.

A loan commitment can also benefit the lender. At a minimum, it confirms that the lender's obligation to make the loan is subject to the satisfaction of specific (and often extensive) conditions. Moreover, the commitment may contractually obligate the borrower to take the loan, if the lender decides to make it. This type of commitment is sometimes called a "bilateral" commitment. In contrast, in an "optional" commitment, the borrower has no duty to take the loan but may do so at its option. Whether a commitment is bilateral or optional, it usually requires the borrower to pay substantial fees that may make it economically expedient for the borrower ultimately to take the loan. The lender also benefits from a loan commitment that contains the borrower's agreement to pay the lender's internal and third party costs incurred in the loan transaction whether or not the loan closes, and that documents the lender's receipt of advance deposits applicable to these fees and costs.

NOTE: Occasionally a lender will not require a loan commitment if the lender has previously made a loan to the same borrower or to an affiliate of that borrower, particularly if the loan is being made on a fast-track basis. Also, in some loan transactions the loan commitment is not executed until shortly before the closing, which eliminates much of the benefit of having a loan commitment.

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II. NEGOTIATING THE LOAN COMMITMENT

§2.2 A. Negotiating Leverage

The timing of the execution of the loan commitment can be an important tool in the loan negotiation process—a fact that borrowers, in particular, may overlook. Borrowers usually have more negotiating leverage before they sign the loan commitment because they often have more time to negotiate, may negotiate with more than one lender, and do not risk losing a nonrefundable commitment fee or purchase deposit if they do not close the loan. As a result, it is usually advantageous for the borrower to negotiate as many issues as possible before executing a commitment. Once the loan commitment is signed, the borrower's ability to negotiate aggressively may be contractually, as well as financially, constrained.

Both lender and borrower often delay contacting an attorney until after they have signed the loan commitment. After the loan commitment is signed, the attorney's ability to negotiate the terms of the loan documents may be limited by specific language in the loan commitment, which in many cases already addresses the most important loan document provisions, such as the right to transfer the property or the constituent ownership interests in the borrower, the recourse obligations of the borrower and any guarantors of the loan, and the borrower's ability to obtain secondary financing.

PRACTICE TIP: Borrower's counsel engaged after execution of the loan commitment should carefully review the provisions of the commitment that control the borrower's negotiating leverage: Is the borrower contractually obligated to take the loan? What fees will be forfeited if the borrower does not take the loan? Are the loan documents subject to the borrower's reasonable approval, or is the borrower obligated to accept the lender's "customary" forms? Even if the borrower is contractually able to walk away from a loan, rising interest rates or time pressure to close a purchase or refinancing may also significantly constrain the borrower's ability to negotiate aggressively. Further, the type of lender providing the loan may influence the borrower's ability to negotiate the loan documents. For securitized or "conduit" loans that require standardized loan documentation, the borrower's counsel may have less flexibility to negotiate certain loan provisions. On securitized and conduit loans, see §§1.18, 1.33, 1.90-1.107, and chap 10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.3 B. Basic Loan Terms

§2.3 B. Basic Loan Terms

A loan commitment sets forth the basic economic terms of the loan, including the following:

- Identity of the lender and borrower;
- Loan amount;
- Maturity date;
- Interest rate, amortization, and payment terms; and
- Security for the repayment of the loan.

Other important items that should be covered are the following:

- Prepayment fees and restrictions;
- Limitations on the lender's recourse against the borrower;
- Events of default, late fees, and cure periods;
- Leasing restrictions;
- Rights to release collateral;
- Insurance requirements and use of proceeds;
- Due-on-sale and due-on-transfer restrictions;
- Reporting requirements;
- Reserves;
- Environmental indemnities; and
- Governing law.

These terms are usually found in the body of the commitment letter but are sometimes found in one or more exhibits (see §2.26). Some commitments paraphrase essential loan terms, others quote the exact language of the relevant loan document, and still others attach standard forms of loan documents—or at least the standard form of certain technical provisions such as nonrecourse carveouts, prepayment premiums, or due-on-sale clauses. Regardless of the method used, the commitment should contain all material terms of the loan. *Peterson Dev. Co. v Torrey Pines Bank* (1991) 233 CA3d 103, 115, 284 CR 367.

The loan commitment will also list the loan documents required to close the loan, such as a loan agreement, promissory note, deed of trust, and security agreement.

PRACTICE TIP: Typically, the lender's commitment form allows for other unnamed documents that the lender may reasonably or customarily require. The borrower should insist that the list of loan documents be as complete as possible.

The attorney's key role is usually the negotiation of the actual loan documents. The loan commitment should set forth the loan terms with specificity. However, the language of some provisions will be presented for the first time when the lender presents the loan documents to the borrower. Like other contracts, a binding loan commitment includes an implied covenant of good faith and fair dealing. See, *e.g.*, *999 v C.I.T. Corp.* (9th Cir 1985) 776 F2d 866; *Teachers Ins. & Annuity Ass'n v Butler* (SD NY 1986) 626 F Supp 1229. Thus the parties must negotiate in good faith toward acceptable loan documents. The commitment, however, usually contains provisions that further specify the parameters of this negotiation—usually in the lender's favor and the implied covenant will not override the express terms of the contract. See *Storek & Storek, Inc. v Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 55, 122 CR2d 267.

Some commitments require the borrower to execute the lender's "customary" or "standard" documents. More favorable to the borrower is language requiring that loan documents be "reasonably acceptable to both parties," or "typical for loans of this type."

To effectively negotiate the loan documents, both lender's and borrower's counsel should understand the contractual and the practical effects of a failure to agree on final language. Even a reasonable failure to agree on loan documents can be costly for both lender and borrower and is cold comfort to a borrower who has posted a nonrefundable

commitment fee.

PRACTICE TIP: It is usually better for both parties to include as much detail as possible in the loan commitment. In addition to bolstering the enforceability of the commitment, it is easier for the parties to focus on the important issues when they are isolated in the loan commitment, rather than scattered throughout voluminous loan documents. See also §2.2.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.4 C. Closing Conditions

§2.4 C. Closing Conditions

The loan commitment specifies the conditions that must be satisfied before the lender will make the loan. Like the basic loan terms, these conditions are placed either in the body of the commitment or in a separate exhibit.

Including a list of the closing conditions as part of the commitment is advantageous for both the borrower and the lender. For the borrower, knowing at the outset what conditions must be satisfied before the lender will close the loan is important for several reasons:

- As a preliminary matter, if any conditions are known to be too difficult or too expensive for the borrower to satisfy, the borrower can decline to execute the loan commitment and thus save the related fees and costs;
- The list of closing conditions can be very useful as a task list for the borrower; and
- The borrower can begin earlier to satisfy the closing conditions.

From the lender's standpoint, including closing conditions in the loan commitment can help avoid disputes with the borrower concerning whether the lender is obligated to close the loan. The lender must be careful, however, to ensure that the list of closing conditions is not too narrow; the lender needs flexibility to avoid closing the loan if a materially adverse condition affecting the borrower, the property, or the general economy makes the loan undesirable to the lender.

Closing conditions typically include the following:

- The borrower's delivering the signed loan documents and the legal opinion;
- The borrower's satisfying its obligations under the commitment, such as payment of fees;
- All representations under the loan documents being true as of the closing;
- The borrower's submitting various due diligence items for the lender's review, and the lender approving these items;
- Receipt of title insurance insuring the priority of the lien of the deed of trust; and
- Receipt of estoppel certificates and subordination agreements from tenants of the property.

See §2.27 for a form exhibit listing closing conditions. If the lender must obtain further internal approvals before the commitment is binding on the lender, they should be also be included as closing conditions.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.5 1. Due Diligence Items

§2.5 1. Due Diligence Items

A lender usually reviews preliminary information regarding the borrower and the collateral before executing the commitment. A typical loan commitment contains several additional due-diligence-related conditions that must be satisfied before closing. These usually include review and approval of the following:

- Organizational documents of the borrower and its general partner or managing member and other principals;
- A preliminary report from a title company and a survey;
- Structural, zoning, and environmental reports;
- A property appraisal;
- Financial information on the borrower and any guarantors;
- UCC searches;
- Tenant estoppels and subordination, nondisturbance, and attornment agreements;
- Insurance policies;
- A rent roll and copies of tenant leases and property-related agreements;
- Applicable permits and certificates of occupancy; and
- Zoning.

See §2.28 for a due diligence checklist listing delivery requirements of borrower.

It is important, especially for borrower's counsel, to confirm that the commitment accurately identifies the conditions that have already been satisfied and those that must be satisfied before the lender will fund the loan.

PRACTICE TIP: Lenders are usually reluctant to modify their standard due diligence requirements. Nevertheless, these requirements are often drafted broadly, leaving lenders some room to be flexible about the information the borrower must provide as a condition to funding the loan. The borrower and other parties may be spared significant time, effort, and expense by even slight modifications of these requirements, *e.g.,* reducing the percentage of tenant estoppels and subordinations, nondisturbance, and attornment agreements that the borrower must obtain, waiving the requirement for a survey in a smaller loan transaction, or waiving a zoning endorsement to the lender's title policy if zoning compliance can be demonstrated by other methods.

It is also important for the borrower's counsel to analyze the standards for the lender's approval of various due diligence items. Although the commitment usually provides that the lender's approval will be based on its "sole and absolute discretion," a reasonableness standard, or another more specifically tailored standard, is often appropriate. See §2.27.

PRACTICE TIP: If the loan is for an acquisition, the borrower should confirm that its due diligence rights under its purchase agreement are adequate to satisfy its due diligence obligations under the loan commitment.

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§2.6 2. Legal Opinions

Loan commitments often require the borrower to deliver such legal opinions as the lender or its counsel may request. Required opinions may include an opinion of counsel licensed in the state or states whose laws govern the transaction, as well as the state or states in which the borrower parties are located, regarding:

- The due formation, valid existence, good standing, and qualification of the borrower and other parties;
- The due authorization, execution, and delivery of the loan documents;
- The enforceability of the loan documents; and
- Other matters.

In addition, the loan commitment may clarify that a perfection opinion is required with respect to the grant of security interests in personal property. In certain larger securitized loans (see §§1.18, 1.33, 1.90-1.107; chap 10), the loan commitment may require a bankruptcy nonconsolidation opinion and, when out-of-state borrowers (most often, from Delaware) are involved, opinions from counsel in that state regarding the structure of the borrowing entities. Borrower's counsel should carefully review the lender's opinion requirements and, if appropriate, negotiate the scope of the opinion to eliminate those opinions that are more labor-intensive, such as an opinion on zoning matters. As with other matters, these issues are most effectively dealt with before the commitment is executed. On legal opinions, see chap 8.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.7 D. Preclosing Rights and Obligations

§2.7 D. Preclosing Rights and Obligations

After the basic terms of the loan documents (see §2.3) and the loan closing conditions (see §§2.4-2.6), the third issue addressed by a loan commitment is the parties' respective rights and obligations from the time the commitment is executed until the loan is closed. This is a more subtle issue than the loan terms or the closing conditions, but it is just as important. It includes the amount, timing, and refundability of the fees the borrower must pay, the extent to which the lender is obligated to make the loan, and the extent to which the borrower must seek to satisfy the closing conditions and, ultimately, take the loan.

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§2.8 1. Lender's Obligations

Although the term "loan commitment" implies a commitment by a lender to make a loan, in fact a typical loan commitment carefully conditions and limits the lender's obligations. Sometimes a "loan commitment" may only be an application by the borrower, creating no obligation of the lender until the commitment is accepted or countersigned by the lender after further internal review and approval.

Even after the lender has "approved" the loan, its obligation to close the loan is often subject to further due diligence review (see §2.5), usually in its sole discretion. The review of some items, such as a survey or a UCC search, is relatively ministerial. The review of other items, however, such as an appraisal or the borrower's or guarantor's financial statements, allows the lender much more discretion. Even if the lender is obligated to make the loan, the interest rate may not be fixed (commonly called a "rate-lock"), until subsequent actions are taken. Moreover, if the lender were to breach its obligation to fund under a loan commitment after all closing conditions were satisfied, the borrower's damages may consist largely of lost profits that may be too speculative to be recoverable.

PRACTICE TIP: Even though the lender is likely to be fairly inflexible about changing the provisions regarding its obligations, the borrower's counsel should review these items carefully with its client so that the client can decide how much reliance to place on the lender's "commitment" at any particular point in the loan transaction.

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§2.9 2. Borrower's Obligations

Although a borrower may believe that the loan commitment primarily binds the lender, it often also places significant obligations on the borrower. These obligations arise in a number of ways. In a bilateral commitment, the borrower will be contractually obligated to satisfy (or use its best efforts to satisfy) the closing conditions and take the loan if the lender offers it. In addition, whether bilateral or optional, the commitment may require the borrower to pay a significant fee, which the borrower forfeits if the loan is not closed. Moreover, rising interest rates or the obligation to close a purchase or refinancing transaction can also exert significant economic pressure on the borrower to close the loan.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.10 3. Fees

§2.10 3. Fees

The loan commitment usually covers two types of fees, which should be, but often are not, clearly delineated:

- Actual out-of-pocket expenses incurred by the lender before the closing, such as outside consulting, legal, engineering, survey, title search fees and expenses, and other comparable costs.
- An amount above out-of-pocket costs, often called a "commitment fee," designed to compensate the lender for in-house costs, opportunity costs, and lost benefit of the bargain if the loan fails to close.

The two key issues regarding fees are amount and refundability. Both vary depending on the function of the fee. A lender may or may not agree to cap the amount of its out-of-pocket fees, depending on the nature of the borrower, the loan, and the lending market. Out-of-pocket fees are rarely refundable, whether or not the loan closes. In some situations, the lender may incur out-of-pocket costs when the rate is "locked" or if the borrower fails to close the loan after the borrower has requested a rate lock. Consequently, the "rate lock" process may require an additional fee and is typically governed by a separate agreement.

WARNING: Rate lock agreements, the substantial deposit amounts they require, and the forfeiture provisions they contain have come under increasing judicial scrutiny. See, *e.g., Wisconn Invs., LLC v Wells Fargo Bank, N.A.* (WD Wisc, June 22, 2009, No. 08-C-0223) 2009 US Dist Lexis 52282 (dispute over application of rate lock deposit to lender's swap rate loss); *Djordjevich v Dexia Real Estate Capital Mkts.* (D Ariz, Nov. 7, 2008, No. CV-08-0288-PHX-DGC) 2008 US Dist Lexis 91253 (dispute over cost to unwind loan commitment based on varying interest rates in rate lock agreement).

A true commitment or standby fee is more typical with a traditional permanent loan take-out commitment. It is the lender's compensation for remaining committed to make the loan for an extended period of time and is nonrefundable.

More common in shorter term commitments is a larger fee (often 1 or 2 percent of the loan amount), which is paid to the lender on execution of the loan commitment and will be refunded if the loan closes. This type of fee is designed to induce the borrower to take the loan and prevent the borrower from "shopping" its loan commitment. In a "bilateral" commitment, it will be characterized as liquidated damages, and in an "optional" commitment as option consideration. Because this type of fee generally is refunded only if the loan closes, it restricts the borrower's ability to aggressively negotiate the loan documents and similar matters once the commitment is signed. In some instances, the borrower may agree in the loan commitment to pay a "breakup" fee to the lender if the borrower shops the loan during the term of the loan commitment, but the fee is not actually deposited with the lender on execution of the loan commitment.

The commitment fee will be nonrefundable if the loan fails to close as a result of a breach by the borrower. Counsel should carefully analyze whether the fee is refunded if there is a failure of a closing condition which is not a result of a breach by the borrower. See §2.21.

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§2.11 III. FORM COMMITMENT LETTER

Loan commitments vary in form. Most are in the form of a letter from the lender to the borrower, which the borrower then signs in agreement. Commitments often incorporate exhibits, which can include descriptions of the property, substantive provisions of the loan documents, and detailed descriptions of various closing conditions. Because the loan commitment letter in §§2.12-2.27 is based on the note and deed of trust in chaps 3 and 4, respectively, this form refers to the loan terms (see §2.26) to facilitate easy reference to the sections in those chapters where the terms are discussed.

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A. Body of Letter

§2.12 1. Form: Introduction and Recitals

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.12-2.28.

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2.12-1 Introduction and recitals

[*Lender's Letterhead*]

_ _[*Date*]_ _

_ _[*Borrower's name and address*]_ _

Re: Proposed Loan Secured by Real Property

Ladies and Gentlemen:

[*Use one of the following two alternatives*]

[*Alternative 1: Borrower is an existing entity*]

You have requested that _ _[*name*]_ _, a _ _[*e.g., California corporation*]_ _ (Lender) make a _ _[*dollar amount*]_ _ loan (the Loan) to _ _[*name*]_ _, a _ _[*e.g., California limited liability company*]_ _ (Borrower) to be secured by certain real property commonly known as _ _[*address or name of property*]_ _ (the Property). This letter (Commitment) evidences the agreement of Lender and Borrower regarding the Loan.

[*Alternative 2: Borrower is an entity yet to be formed*]

You have requested that _ _[*name*]_ _, a _ _[*e.g., California corporation*]_ _ (Lender) make a _ _[*dollar amount*]_ _ loan (the Loan) to a single-purpose entity (Borrower) to be formed and in which _ _[*name*]_ _ (Applicant) will have a controlling interest to be secured by certain real property commonly known as _ _[*address or name of property*]_ _ (the Property). This letter (Commitment) evidences the agreement of Lender and Applicant regarding the Loan.

Comment: Parties should confirm that the borrower and lender are correctly named. Commitments are occasionally entered into by parties other than the party who will either make or take the loan. Failing to provide the lender with the correct entity may result in additional due diligence requirements for the new entity and closing delays. In securitized loans, the lender frequently requires the borrower to be a single-asset entity. In that event, alternative 2 should be used and the remaining provisions of the commitment must be revised to reflect the different roles of the applicant and the borrower. Additional requirements should be described if the borrower must also be a bankruptcy-remote entity. (For further discussion of securitized loans, see §1.96.)

In a commitment, it is generally sufficient to use a street address to identify the property. If there is any risk of confusion, the commitment can refer to a legal description of the property. Additional relevant facts should be included, such as if the borrower has less than a fee interest or if the borrower intends to release a portion of the collateral after the closing.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.13 2. Form: Loan Terms

§2.13 2. Form: Loan Terms

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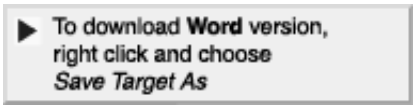

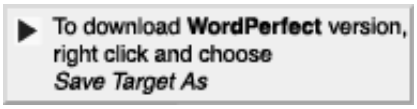

2.13-1 Loan terms

1. Loan Terms. Attached as Exhibit A to this letter is a Summary of Loan Terms (the Summary), which contains a list of the final loan documents to be used in connection with the Loan (the Loan Documents) and which outlines certain material terms of the Loan but does not include all provisions that shall be contained in the Loan Documents. The Loan Documents shall contain the terms and conditions set forth in the Summary and such other indemnities, covenants, representations, and warranties, events of default, security arrangements, and other provisions as are _ _[*acceptable to Lender in its sole discretion/typically included in Lender's standard Loan Documents for loans of this type/customary for loans of this type/acceptable to Borrower in its reasonable discretion/acceptable to Borrower in its sole discretion*]**_ _.**

Comment: The summary of loan terms (see §2.26) should include all material business terms of the loan. The bracketed language at the end of paragraph 1 provides examples of methods to describe the standard for the provisions not summarized in the commitment (ranging from a very lender-oriented standard to a very borrower-oriented one). See §2.3.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.14 3. Form: Closing Conditions

§2.14 3. Form: Closing Conditions

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2.14-1 Closing conditions

2. Closing Conditions. Lender agrees to make the Loan to Borrower, subject to the terms of this Commitment and subject to Borrower's satisfying each condition set forth in Exhibit B (the Closing Conditions).

[*Add one of the following three alternatives*]

[*Alternative 1: Borrower unconditionally obligated to satisfy closing conditions*]

Borrower agrees to take and to borrow the Loan from Lender and to satisfy (or cause to be satisfied) each of the Closing Conditions on or before the Expiration Date (as defined in _ _[*e.g., paragraph 3*]_ _).

[*Alternative 2: Borrower to use best efforts to satisfy closing conditions*]

Borrower agrees to take and to borrow the Loan from Lender and to use its best efforts to satisfy (or cause to be satisfied) each of the Closing Conditions on or before the Expiration Date (as defined in _ _[*e.g., paragraph 3*]_ _).

[*Alternative 3: Borrower has no obligation to satisfy the closing conditions*]

Borrower shall have the option, but not the obligation, to take and borrow the Loan from Lender and has no obligation to satisfy (or cause to be satisfied) the Closing Conditions.

Comment: The alternatives provide a range of lender- to borrower-oriented choices regarding the borrower's obligations to take the loan and to satisfy closing conditions. Alternative 1 or 2 is appropriate for a "bilateral" commitment. Alternative 3 is used in an "optional" commitment.

Generally, the list of closing conditions is fairly detailed and is sometimes made a part of the commitment. The loan commitment may include certain standard conditions in the text with an accompanying exhibit listing additional conditions specific to the particular loan transaction. On closing conditions, see §§2.4-2.6.

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§2.15 4. Form: Expiration Date

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2.15-1 Expiration date

3. Expiration Date. This Commitment will expire at 12 noon (Pacific time) on _ _[*date*]_ _ (the Expiration Date). If the closing conditions have not been satisfied and the Loan funded (the Closing) by the Expiration Date, the parties' obligations under this Commitment to close the Loan shall cease. Time is of the essence of this Commitment and is a material term of the parties' agreement. If the Closing of the Loan has not occurred by the Expiration Date, all rights of Borrower to obtain the Loan shall automatically and immediately terminate without notice. Follow ing such termination, Borrower's rights may not be revived by any subsequent action or performance by Borrower.

Comment: Timing is often more important to the borrower than to the lender. If the loan is part of a transaction that has its own timing requirements, the borrower may need to negotiate additional flexibility. The lender may have timing concerns, *e.g.,* when the lender wants to close and book a loan before the end of the year or calendar quarter or before a scheduled loan securitization (see chap 10). If the borrower has entered into a rate lock agreement (see §§2.10, 2.25A) with the lender, the borrower's failure to satisfy the closing conditions before the expiration of the rate lock may cause the lender to incur substantial costs that ultimately will be paid by the borrower. For a more detailed "time is of the essence" provision, see paragraph 49.6 in 4.114-1.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.16 5. Form: Commitment Fee

§2.16 5. Form: Commitment Fee

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2.16-1 Commitment fee

[*Add one of the following two alternatives*]

[*Alternative 1: Bilateral commitment fee refundable on closing; liquidated damages if loan fails to close*]

4. Commitment Fee. As consideration for this Commitment, Borrower shall pay Lender a fee (the Commitment Fee) in the amount of _ _[*e.g., 1 to 2*]_ _ percent of the Loan amount (_ _[*dollar amount of fee*]_ _). The Commitment Fee shall be refunded to Borrower if the Loan closes. If the Loan does not close, the Commitment Fee shall be nonrefundable unless the Loan fails to close because of a material breach by Lender of its obligations under this Commitment. The Commitment Fee shall be delivered to Lender concurrently with the execution and delivery of this Commitment. This Commitment shall become effective on Lender's receipt of a copy of this Commitment executed by or on behalf of Borrower, the Commitment Fee, and the Report Deposit (described in _ _[*e.g., paragraph 6*]_ _).

[*Alternative 2: Optional commitment; fee nonrefundable*]

4. Commitment Fee. As consideration for this Commitment, Borrower shall pay Lender a fee (the Commitment Fee) of _ _[*dollar amount*]_ _ as compensation for an option to borrow the funds offered by this Commitment and for Lender's processing costs and holding the Loan available. The Commitment Fee shall be nonrefundable and payable whether or not the Loan closes, unless the Loan fails to close because of a material breach by Lender of its obligations under this Commitment. Borrower shall have no obligation to take or borrow the Loan. The Commitment Fee shall be delivered to Lender concurrently with the execution and delivery of this Commitment. This Commitment shall become effective on Lender's receipt of a copy of this Commitment executed by or on behalf of Borrower, the Commitment Fee, and the Report Deposit (described in _ _[*e.g., paragraph 6*]_ _).

Comment: In Alternative 1, used with a "bilateral" commitment, the lender claims the right to retain the commitment fee as liquidated damages if the loan fails to close even if the borrower does not breach its obligations under the commitment. Borrower's counsel should negotiate for a refund of the commitment fee unless the loan fails to close as a result of the borrower's material breach. See discussion of commitment fees in §2.10 and of liquidated damages in Comment in §2.20.

Alternative 2 is used in an "optional" commitment. By clearly providing that the commitment fee is a payment for the borrower's option to borrow, the lender can avoid the burdens of justifying the fee as valid liquidated damages and of proving an unexcused breach of the commitment agreement by the borrower. If alternative 2 is used, a liquidated damages provision (see, *e.g.*, form 2.20-1) should *not* be used.

For discussion of enforceability issues under either approach, see Anno, *Enforceability of Provision in Loan Commitment Agreement Authorizing Lender to Charge Standby Fee, Commitment Fee, or Similar Deposit*, 93 ALR3d 1156 (1979).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.17 6. Form: Lender's Costs

§2.17 6. Form: Lender's Costs

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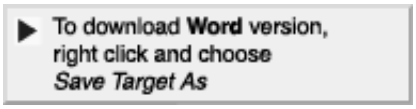

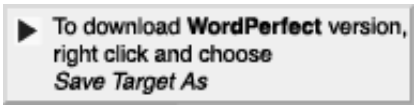

2.17-1 Lender's costs

5. Costs and Expenses. Borrower shall pay all costs and expenses _ _[*reasonably*]_ _ incurred in connection with the preparation for and the Closing of the Loan, whether the Loan closes or not, including appraisal fees, engineering examination fees, environmental audit fees, inspection fees, credit report fees, insurance policy review fees, underwriter's fees, surveyor's fees, legal fees (including fees of counsel and local counsel for Lender), note taxes, mortgage taxes, stamp taxes, transfer taxes, all recording costs and filing fees, all license and permit fees, all title, UCC, litigation, tax lien, and background search fees, and all title and other insurance premiums (Lender's Costs). Lender shall bear no out-of-pocket costs or expenses whatsoever in connection with this Commitment or the Loan. Borrower shall pay all Lender's Costs within _ _[*e.g., 5*]_ _ days after Lender's written demand. This provision shall survive the Closing and the expiration or termination of this Commitment.

Comment: This provision governs the lender's costs and expenses. The borrower should request estimates of these amounts or try to limit them by either imposing a cap or limiting the costs and expenses to those reasonably incurred. Most lenders resist limitations on their ability to recover transaction costs from the borrower. Even when limits are imposed, many lenders will condition the limits on the satisfaction of certain relevant conditions, and provide that the limits should not apply if exceeded owing to unanticipated events or to circumstances within the borrower's control. On expenses, see §2.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.18 7. Form: Report Deposit

§2.18 7. Form: Report Deposit

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2.18-1 Report deposit

6. Report Deposit. Borrower has made or shall make a non-interest-bearing deposit with Lender in the amount of _ _[*dollar amount*]_ _ (the Report Deposit) for the estimated costs and expenses of obtaining any appraisal, engineering report, environmental report, insurance consultant report, credit report, or any other third party report obtained by Lender (the Reports). The Report Deposit shall be used to pay the costs of the Reports, and any excess shall be applied to Lender's Costs, and the remaining portion of the Report Deposit, if any, shall be returned to Borrower. If the Report Deposit is not sufficient to pay the costs of the Reports, then Borrower must pay to Lender the additional amount needed to pay such costs or expenses in full within _ _[*e.g., 5*]_ _ days after Lender's written demand.

Comment: The lender often requires the borrower to provide a deposit for the lender's out-of-pocket costs even before the commitment is executed.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.19 8. Form: Loan Brokerage and Other Fees

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2.19-1 Loan brokerage and other fees

7. Brokerage Fees. Lender is not obligated to pay any loan commission and/or brokerage fee in connection with this Commitment, Lender's acceptance of this Commitment, or the Closing of the Loan.

[*Add one of the following three alternatives*]

[*Alternative 1: Borrower warrants no loan brokerage*]

Borrower represents and warrants that it has not dealt with any finder or broker in connection with this Commitment. The Borrower shall pay, at or before Closing, all commissions and fees owed to any person or party, and agrees to indemnify, defend, and hold Lender harmless from and against any and all claims made against Lender, and liabilities, obligations, damages, costs, and expenses (including attorney fees and disbursements) incurred by Lender in connection with any claims that are asserted, by any broker whom Borrower has, or is alleged to have, engaged in connection with the Loan or any other person claiming by, through, or under Borrower in connection with the Loan. The foregoing representation and indemnity shall survive the expiration or termination of this Commitment, or the Closing, as applicable.

[*Alternative 2: Borrower acknowledges loan brokerage*]

Borrower acknowledges that, in addition to Lender, it has dealt with _ _[*name*]_ _ (Broker) in connection with this Commitment and that Borrower has agreed to pay Broker a brokerage fee in the amount of _ _[*dollar amount*]_ _ in connection with the Loan. Borrower represents and warrants that it has not dealt with any other finder or broker in connection with this Commitment. The Borrower shall pay, at or before Closing, any and all commissions and fees due to any person or party including, without limitation, Broker, and agrees to indemnify, defend, and hold Lender harmless from and against any and all claims made against Lender, and liabilities, obligations, damages, costs, and expenses (including attorney fees and disbursements) incurred by Lender in connection with any claims that are asserted by any broker whom Borrower has, or is alleged to have, engaged in connection with the Loan or any other person claiming by, through, or under Borrower in connection with the Loan. The foregoing representation and such indemnity shall survive the expiration or termination of this Commitment, or the Closing, as applicable.

Comment: Both of the above alternatives contemplate that the lender has no responsibility for brokerage fees. If there is a loan broker, there may also be a separate agreement between the borrower and the broker.

[*Alternative 3: Disclosure of compensation paid by lender to borrower's broker*]

Borrower acknowledges that Lender may elect in its sole discretion to compensate Broker in connection with the Loan or otherwise pursuant to a separate agreement between Lender and Broker, and Lender shall have no obligation to disclose to Borrower the existence of any such agreement or the amount of any such additional consideration paid or to be paid to Broker whether in connection with the Loan or otherwise.

Comment: The lender may agree to compensate the borrower's broker beyond any compensation payable by the borrower to the broker. Such compensation is frequently paid when the broker normally would seek to provide the servicing for the loan after origination but instead releases the servicing rights to the originating lender in exchange for additional compensation. The compensation may take the form of a yield spread premium, whereby the broker receives a certain portion of the interest payments during the loan term. Even in the absence of a legal obligation to disclose, many commercial lenders choose to alert the borrower to the possible existence of such an arrangement. On brokers and broker compensation generally, see California Real Estate Brokers: Law and Litigation (Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.20 9. Form: Liquidated Damages

§2.20 9. Form: Liquidated Damages

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2.20-1 Liquidated damages

8. LIQUIDATED DAMAGES. LENDER AND BORROWER HAVE DISCUSSED THE POSSIBLE CONSEQUENCES TO LENDER IF THE LOAN FAILS TO CLOSE. LENDER AND BORROWER HAVE AGREED THAT A PORTION OF LENDER'S DAMAGES CAN BE FIXED BY (a) BORROWER'S PAYMENT OF LENDER'S COSTS DESCRIBED IN _ _[*e.g., PARAGRAPH 5*]_ _ (SUBJECT TO THE DUTY TO PROVIDE AN ACCOUNTING AND TO REFUND ANY REMAINING PORTION OF THE REPORT DEPOSIT, AS PROVIDED IN _ _[*e.g., PARAGRAPH 6*]_ _), AND (b) LENDER'S ENFORCEMENT OF ITS RIGHT TO INDEMNITY UNDER _ _[*e.g., PARAGRAPH 10*]_ _ OF THIS COMMITMENT (THE FIXED DAMAGES). LENDER AND BORROWER HAVE ALSO AGREED THAT LENDER WOULD SUFFER ADDITIONAL DAMAGES IN EXCESS OF THE FIXED DAMAGES, INCLUDING, BUT NOT LIMITED TO, LOSS OF INCOME FROM ALTERNATIVE INVESTMENTS, AND AGREE THAT IT WOULD BE IMPRACTICAL OR EXTREMELY DIFFICULT TO FIX THESE ADDITIONAL DAMAGES TO LENDER IF THE LOAN FAILS TO CLOSE (EXCEPT AS THE RESULT OF LENDER'S MATERIAL BREACH OF ITS OBLIGATIONS UNDER THIS COMMITMENT). THE PARTIES, HAVING MADE DILIGENT BUT UNSUCCESSFUL ATTEMPTS TO ASCERTAIN THE ACTUAL ADDITIONAL COMPENSATORY DAMAGES LENDER WOULD SUFFER IN THIS EVENT, AGREE THAT A REASONABLE ESTIMATE OF SUCH ADDITIONAL DAMAGES IS AN AMOUNT EQUAL TO THE COMMITMENT FEE. IF THE LOAN FAILS TO CLOSE (EXCEPT AS THE RESULT OF LENDER'S MATERIAL BREACH OF ITS OBLIGATIONS UNDER THIS COMMITMENT), LENDER SHALL BE ENTITLED TO RECEIVE AND RETAIN, IN ADDITION TO THE FIXED DAMAGES, AS FULLY AGREED LIQUIDATED DAMAGES FOR LENDER'S ADDITIONAL COMPENSATORY DAMAGES, THE ENTIRE COMMITMENT FEE. ALL OTHER CLAIMS AND REMEDIES (OTHER THAN CLAIMS AND REMEDIES RELATED TO THE FIXED DAMAGES) ARE EXPRESSLY WAIVED BY LENDER.

BORROWER'S INITIALS: _____

LENDER'S INITIALS: _____

Comment: This liquidated damages provision is *not* needed and should *not* be used in an optional commitment, *i.e.*, if alternative 2 in paragraph 4 (see form 2.16-1) is elected. This provision is appropriate if the commitment requires the borrower to take the loan, and it permits the lender's retention of the commitment fee after the borrower's breach and even on the failure of a condition without a breach. The lender's retention of a bilateral commitment fee without a borrower's breach raises questions of both enforceability and fairness. Borrower's counsel should negotiate for a provision imposing liquidated damages only if the loan fails to close because of the borrower's material breach.

Although not required to be in all capital letters or in a certain size type for a commercial loan, by custom liquidated damages provisions are usually so set off to draw the borrower's attention to them. A provision allowing the lender to retain the commitment fee must meet the statutory requirements for a valid liquidated damages provision (CC §1671), or the lender must be able to prove actual damages at least equal to the fee. The burden is on the borrower to invalidate a liquidated damages provision. See CC §1671.

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§2.21 10. Form: Termination Events

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.12-2.28.

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2.21-1 Termination events

9. Termination Events. If at any time Lender finds that any of the following exist, Lender may terminate its obligations under this Commitment (the Termination Events):

9.1. Material Adverse Change. A material adverse change occurs in the assets, financial condition, or income of Borrower or the Property;

9.2. Material Negative Impact. Lender becomes aware of information not previously known or disclosed to it, which Lender believes has a material negative impact on its analysis of the business, assets, financial condition, or income of Borrower or the Property;

9.3. Material Litigation. Except as previously disclosed to Lender, material litigation or other material action by third parties is pending or threatened seeking an injunction, damages, or other relief relating to Borrower, the Property, or the Loan;

9.4. Assignment or Transfer. Borrower assigns or transfers this Commitment or any of its rights, benefits, or duties under it; or

9.5. Borrower's Breach. Borrower otherwise breaches its obligations under the Commitment.

On the occurrence of a termination event, Lender may retain the Commitment Fee and the Report Deposit except any amounts to be refunded under _ _[*e.g., paragraphs 4, 6, and 8*]_ _, and such termination will not terminate Borrower's liability for Lender's Costs.

Comment: These termination events are lender-oriented. The borrower should at least argue that the commitment fee be refunded unless the termination event results from the borrower's material breach of paragraph 9.5 of the form. See §2.10.

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§2.22 11. Form: Indemnity

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2.22-1 Indemnity

10. Indemnity. By accepting this Commitment, Borrower agrees to indemnify and defend Lender and its directors, officers, shareholders, employees, agents, attorneys, representatives, consultants, parent companies, affiliates, and subsidiaries against all losses, claims, damages, liabilities, and expenses incurred by or asserted against any such indemnitee in connection with or arising from or through Borrower, regarding this Commitment, the Loan Documents, or related matters, except to the extent resulting from the indemnitee's gross negligence or willful misconduct.

Comment: This paragraph reflects the lender's concern with liability to third parties in a real estate transaction. For example, if a borrower is unable to complete its purchase obligation, a disgruntled seller may allege that the lender interfered with contractual relations.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.23 12. Form: Assignment

§2.23 12. Form: Assignment

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2.23-1 Assignment

11. Assignment. Without Lender's express written consent, Borrower may not assign or transfer this Commitment or any of its rights, benefits, or duties to any other person or entity.

Comment: If the borrower plans to assign the commitment to a related entity, this provision should be so modified. See Comment in §2.12.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.24 13. Form: Miscellaneous

§2.24 13. Form: Miscellaneous

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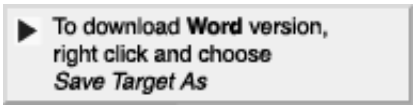

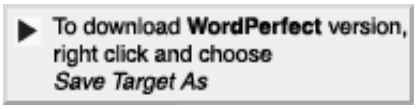

2.24-1 Miscellaneous

12. <u>Miscellaneous</u>. If any party to this transaction brings an action or proceeding to enforce the terms of this Commitment, the prevailing party in that action or proceeding shall be entitled to reasonable attorney fees. This Commitment constitutes the entire understanding of Lender and Borrower with respect to the Loan and supersedes all prior and current understandings and agreements, whether written or oral. This Commitment may not be amended or modified except in a writing executed by both parties.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.25 14. Form: Acceptance and Signatures

§2.25 14. Form: Acceptance and Signatures

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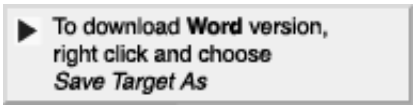

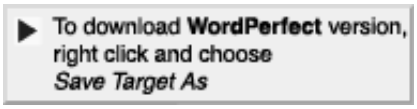

2.25-1 Acceptance and signatures

13. <u>Acceptance</u>. This Commitment is presented in two identical originals, each executed by Lender, and shall be of no force or effect unless on or before _ _[*date*]_ _, Lender has received one copy duly executed by Borrower evidencing Borrower's acceptance of this Commitment and agreement to its terms, together with the Commitment Fee and Report Deposit.

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B. Optional Provisions for Commitment Letter

§2.25A 15. Form: Early Rate Lock

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.12-2.28.

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2.25A-1 Early rate lock

14. Early Rate Lock. Borrower shall have the option to lock the interest rate at, or any time after, the time of commitment provided that Borrower deposits a standby fee with Lender equal to _ _ _ percent of the amount of the Loan and for an increase of _ _ _ basis points in the interest rate.

The standby fee shall be in addition to the fees described in this Commitment and will be governed by a formal Rate Lock Agreement provided to Borrower that generally will entitle Borrower to a refund of the standby fee if the Loan closes on or before the expiration of the Loan Commitment, but would be forfeited by Borrower in its entirety if the loan does not close before the expiration of the Loan Commitment for any reason.

Comment: For a further discussion of rate locks, see §2.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.25B 16. Form: Subordinate Financing

§2.25B 16. Form: Subordinate Financing

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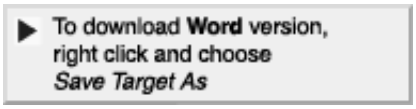

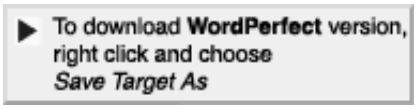

2.25B-1 Subordinate financing

15. <u>Subordinate Financing</u>. Subordinate financing shall be prohibited for the term of the Loan and no subordinate debt instrument of any kind or other lien or encumbrance against the Property will be allowed at any time during the term of the Loan. A pledge of any of the ownership interest in the borrowing entity shall constitute secondary financing and shall be prohibited for the term of the Loan.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.25C 17. Form: Transfers

§2.25C 17. Form: Transfers

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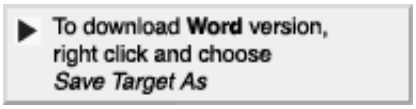

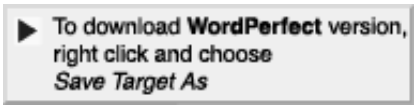

2.25C-1 Transfers

16. Transfers. Borrower may not sell convey, mortgage, grant, bargain, encumber, pledge, assign, or otherwise transfer the Property or any part of it, or any direct or indirect interest in Borrower or the Property, without Lender's prior written consent. Borrower _ _[*and Borrower's constituent entities*]**_ _ may not incur any debt, secured or unsecured, direct or contingent (including guaranteeing any obligation), other than the Loan and trade payables incurred by Borrower in the ordinary course of business, provided the same are paid when due. No more than _ _**[*e.g., forty-nine*]**_ _ percent of the beneficial interests in Borrower _ _**[*and Borrower's constituent entities*]**_ _ may be transferred or pledged without the prior written consent of Lender.**

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§2.25D 18. Form: Recourse Carveouts

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2.29-1 Recourse carveouts

17. Recourse Carveouts. The Note will be non-recourse to Borrower _ _[*and the Guarantor(s)*]**_ _, except that Borrower_ _**[*,/and*]**_ _ any general partner of Borrower _ _**[*, and Guarantor(s)*]**_ _ will be personally liable, both jointly and severally, for the amount of:**

(a) any loss, damage or cost resulting from (i) fraud or intentional misrepresentation by Borrower in connection with obtaining the Loan evidenced by the Note, (ii) insurance proceeds, condemnation awards, or other sums or payments attributable to the Property not applied in accordance with the provisions of the Loan Documents, except to the extent that Borrower did not have the legal right, because of a bankruptcy, receivership, or similar judicial proceeding, to direct disbursement of such sums or payments, (iii) all rents, profits, issues, products, and income of the Property received following any event of default under the Loan Documents and not applied to payment of principal and interest due under the Note (including any received or collected by or on behalf of Borrower after an event of default, except to the extent that Borrower did not have the legal right, because of a bankruptcy, receivership, or similar judicial proceeding, to direct the disbursement of such sums), and the payment of actual and reasonable operating expenses of the Property, as they become due or payable, (iv) misappropriation of tenant security deposits and rents collected in advance or any funds held by Borrower for the benefit of another party, (v) a claim by a tenant at the Property against Lender for any act or omission of Borrower, any offsets or defenses which any tenant at the Property claims against Borrower, or a claim for any false representation, breach of warranty, or any act of, or failure to act, by Borrower, (vi) waste of the Property, (vii) Borrower's failure to pay transfer fees and charges due Lender under the Loan Documents in connection with any subordinate financing or any transfer of all or any part of the Property, or any interest in the Property, from Borrower to Borrower's transferee, or transfer of beneficial interest in Borrower (if Borrower is not a natural person or persons but is a corporation, partnership, trust, or other legal entity), (viii) failure by Borrower _ _[*,/or*]**_ _ any general partner or member of Borrower _ _**[*,/or any Guarantor*]**_ _ to comply with the covenants, obligations, liabilities, warranties, and representations regarding environmental matters, (ix) in the event Lender has waived the monthly collection for real and personal property taxes and insurance premium, then failure by Borrower to pay all real property taxes and assessments or personal property taxes, or, (x) in the event Lender has waived the requirement for third party property management, then any management fee taken by Borrower or any principal of Borrower after an event of default, or (xi) termination of the _ _**[*identify lease*]**_ _ lease as a result of a landlord default, and**

(b) the Loan in the event of (i) a termination of the _ _[*identify lease*]**_ _ lease as a result of a landlord default, (ii) a breach of the due on sale or further encumbrance prohibition, (iii) in the event of a bankruptcy filing or other similar event by Borrower _ _**[*or (iv) a breach of the single-asset covenants in the Loan Documents*]**_ _.**

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.25E 19. Form: Loan Assumptions

§2.25E 19. Form: Loan Assumptions

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2.20E-1 Loan assumptions

18. Loan Assumptions. The Loan may not be assigned by Borrower or assumed without the prior written consent of Lender _ _[*which consent shall not be unreasonably withheld or delayed*]**_ _. In connection with any assignment and assumption of the Loan, Borrower shall pay to Lender all reasonable and customary expenses incurred by Lender in connection with the Loan and an assumption fee in an amount equal to _ _ _ percent of the then outstanding principal amount of the Loan as of the date of assumption. Borrower shall furnish Lender at Borrower's sole cost and expense any information that Lender shall request in connection with any assignment or assumption, including, without limitation, an appraisal or other evidence satisfactory to Lender in its sole and absolute discretion of the value of the Property as of the date of assumption. The assignee shall assume Borrower's duties and obligations under the Loan Documents and shall execute and deliver to Lender such documents, guaranties, opinions, certificates, and information as Lender reasonably requires to effectuate such assumption. No sale, assignment, or assumption shall relieve Borrower of its obligations under the Loan Documents without Lender's prior written consent.**

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§2.25F 20. Form: Securitization Cooperation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.12-2.28.

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2.25F-1 Securitization cooperation

19. Securitization Cooperation. Lender shall have the right at any time, either before or after the closing of the Loan, (a) to participate, syndicate, or securitize all or any portion of its interest in the Loan, (b) to cause the Loan to be split into senior and one or more junior or mezzanine loans in whatever proportion Lender deems appropriate (which loans may be secured by mortgages and/or a pledge of direct or indirect partnership or membership interests in Borrower), and (c) to create one or more senior and subordinate notes (i.e., an A/B or A/B/C structure) or multiple components of such note or notes, and thereafter to sell, assign, participate, syndicate, or securitize all or any part of any variant of the Loan (any of the foregoing, a "Secondary Market Transaction"). Borrower shall agree to cooperate with Lender to facilitate any Secondary Market Transaction and the rating of the Loan (or any resulting variant thereof) and of each securitization in which one or more loans are included. Borrower's cooperation obligation shall continue until the Loan has been repaid in full, and shall include, without limitation, the following as each may be required from time to time by Lender, any servicer of the Loan, or any holder of the Note: (a) consenting to reasonable, non-material modifications to the Loan Documents or to Borrower's organizational documents, which modifications shall not increase the Borrower's obligations nor diminish any of Borrower's rights in connection with the Loan; and, (b) provision of information including property rent rolls and operating statements, tenant financial statements and sales data (to the extent Borrower is entitled to receive them under a lease agreement), existing reports, copies of notices, and reasonable access to the Property, the property manager and to personnel of Borrower and its affiliates. _ _[*Borrower shall not be required to incur any unreimbursable out-of-pocket cost or expense in connection with Borrower's performance of its cooperation obligation hereunder.*]_ _

Sincerely,

_ _[*Name of lender*]_ _

By: __[*Signature*]__**Lender**

ACCEPTED, ACKNOWLEDGED, AND AGREED:

Borrower

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California limited liability company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: If the loan is one of several loans that are cross-collateralized and cross-defaulted, then this provision should be expanded to allow the lender, if desired, to "uncross" the loans in connection with securitization (explained in §§1.18, 1.33, 1.90-1.107 and chap 10).

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C. Exhibits

§2.26 1. Form: Exhibit A (Summary of Loan Terms)

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.12-2.28.

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2.26-1 Summary of loan terms

BORROWER: _ _[*Name and capacity of borrower (see §3.60)*]_ _

GUARANTOR: _ _[*Name and capacity of any guarantor (see §6.2)*]_ _

LENDER: _ _[*Name and capacity of lender (see §3.60)*]_ _

LOAN AMOUNT: _ _[*Original principal amount (see §§1.74, 3.60)*]_ _

TERM: See §§3.8-3.9, 3.64.

INTEREST RATE: See §§3.11-3.14, 3.61, 3.63, 3.81-3.83.

AMORTIZATION: See §§1.28, 3.8, 3.64.

RECOURSE: See §§1.51, 3.49-3.51, 3.97.

COLLATERAL: See §§4.18, 4.66 (paragraph 1.19).

LOAN ASSUMPTION: See §§4.43, 4.85 (paragraphs 20.3-20.4).

PREPAYMENT: See §§1.50, 3.22-3.34, 3.64, 3.87-3.94.

LOAN DOCUMENTS: See §4.66 (paragraph 1.18).

DUE ON SALE: See §§4.43, 4.85.

EVENTS OF DEFAULT: See §§3.35, 3.52, 3.65, 3.98, 4.42, 4.84.

LEASING RESTRICTIONS: See §§4.30-4.32, 4.59, 4.120.

INSURANCE: See §§4.24, 4.26, 4.69.

ENVIRONMENTAL: See §§4.47, 4.89.

GOVERNING LAW: See §§3.48, 3.75, 4.55, 4.100.

This Summary of Loan Terms is not intended to be, and should not be construed as, an attempt to establish all terms and conditions relating to the Loan. It is intended only to be indicative of certain major terms and conditions on which the loan documents will be structured, and it is not intended to preclude negotiations within the general scope of these terms and conditions.

Comment: On basic loan terms, see §2.3.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.27 2. Form: Exhibit B (Conditions of Lender's Obligation to Fund Loan)

§2.27 2. Form: Exhibit B (Conditions of Lender's Obligation to Fund Loan)

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.12-2.28.

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2.27-1 Conditions of lender's obligation to fund loan

Lender's obligation to fund the Loan under this Commitment is subject to the fulfillment, to Lender's _ _[*reasonable satisfaction/sole discretion*]_ _, of each of the following conditions precedent, including Lender's approval, in its_ _[*reasonable satisfaction/sole discretion*]_ _, of each item delivered in connection with this Commitment:

1. Representations and Warranties True at Closing. The representations and warranties made by or on behalf of Borrower in any of the Loan Documents or in any certificate, written statement, or other writing given in connection with the Loan (including, but not limited to, all financial and operating statements), taken as a whole, shall be true and correct on and as of the Closing with the same effect as if made at such time.

2. No Default. There shall be no Default, as defined in any of the Loan Documents, or any event, omission, or failure of condition that would constitute a Default after notice or lapse of time, or both.

3. Performance. Borrower shall perform and comply with all agreements and conditions in this Commitment.

4. Loan Documents. Lender shall have received all Loan Documents, instruments, policies, and forms of evidence or other materials requested by Lender under the terms of this Commitment or any of the Loan Documents.

5. Reports, Studies, and Permits. Borrower shall have delivered to Lender any of the following items in the possession of Borrower or any of its agents: (a) engineer's soil, structural, seismic, or environmental reports on the Property; (b) "as built" plans and specifications for the Improvements; (c) copies of all agreements that were material to completion of the Improvements; and (d) copies of a final certificate of occupancy, a final building permit, or other evidence of completion in accordance with building codes and regulations and compliance with zoning requirements, including parking requirements.

6. Hazardous Materials. Lender shall have received a Phase I environmental assessment report in form and substance satisfactory to Lender from a licensed engineer acceptable to Lender.

7. Engineering Report. Lender shall have received an engineering report in form and substance satisfactory to Lender from a licensed engineer acceptable to Lender

8. Earthquake Report. Lender shall have received from a licensed engineer acceptable to Lender, a report in form and substance satisfactory to Lender on the Property stating the probable maximum loss to the Property resulting from seismic events. The report should include, but shall not be limited to, a soil analysis, a structural analysis, a soil-structure interaction analysis, proximity to known faults, and seismic history.

9. Title Insurance. Lender shall have received a lender's ALTA extended coverage policy of title insurance, together with such endorsements and reinsurance as required by Lender (such policies, endorsements, and reinsurance being referred to here as the Title Policy), in the amount of the Loan and issued by _ _[*name of issuer*]_ _ (the Title Company) _ _[*a national title company approved by Lender*]_ _, in form and substance satisfactory to Lender, insuring that Borrower is the owner of the Property in fee simple, and that the Deed of Trust is a valid first lien on the Property in favor of Lender, free and clear of all liens, encumbrances, and exceptions to title whatsoever, other than (a) current real property taxes not delinquent and (b) such exceptions as are approved in writing by Lender.

10. Survey. Lender shall have received _ _[*e.g., two*]_ _ copies of _ _[*a/an ALTA*]_ _ survey of the Property in form and substance satisfactory to Lender (a) prepared and dated no more than _ _[*e.g., 3*]_ _ months before the Closing by a registered surveyor reasonably satisfactory to Lender, (b) certified as correct, and (c) sufficient to allow the Title Company to issue the Title Policy without a general survey exception.

11. UCC-Filing Office Certificate. Lender shall have received a Certificate of the Secretary of State (or other applicable filing office of the state in which the Property is located, the state in which the Borrower is located, and such other locations as Lender may request responding to a request for information (Com C §§9523(c) and 9528 or equivalent) and certifying that there is not on file with the Secretary of State's Office (or such other UCC filing office) any effective financing statement, statements of assignment, federal or state tax lien, attachment lien, or other security interest perfectible by the filing of a financing statement with respect to Borrower or the Property.

12. Documents. Lender shall have received from Borrower such certificates, opinions, and other documents as Lender may request and as are consistent with this Commitment and the other Loan Documents, including, but not limited to, documents evidencing the organization, existence, and authority of Borrower, and the authority of the persons executing this Commitment and the other Loan Documents to execute the same for and on behalf of Borrower.

13. Insurance. Lender shall have received the policies of insurance (or certificates) as required by the Deed of Trust.

14. Appraisal. Lender shall have received an appraisal of the Property in form and substance satisfactory to Lender.

15. Consents. Borrower shall have delivered to Lender evidence satisfactory to Lender establishing that Borrower has all consents, permits, and approvals from any and all government authorities having jurisdiction over Borrower and/or the Property that are required in connection with the Property.

16. Financial Statements. Lender shall have received originally signed and dated financial statements for Borrower in form and substance satisfactory to Lender.

17. Payment of Fees and Expenses. Borrower shall have paid to Lender on or before the Closing all fees and the expenses required by Lender in connection with the Loan as provided in this Commitment.

18. Leases and Management Agreement. Borrower shall have delivered to Lender (a) copies of all signed leases and any amendments and lease guarantees for the Property, (b) a standard form lease used by Borrower for the Property in form and substance reasonably acceptable to Lender, (c) income and expense statements for the Property in the possession of Borrower or its agents, (d) the current management agreement for the Property if a third party contractor is employed by Borrower to manage the Property, (e) a current itemized and certified rent roll for the Property, (f) an estoppel certificate executed by tenants occupying the Property representing (i) _ _[*e.g., 100*]_ _ percent of the tenants leasing over _ _[*e.g., 10,000*]_ _ square feet and (ii) _ _[*e.g., 75*]_ _ percent of the tenants (by square footage) of the Property, in form and substance satisfactory to Lender in its sole discretion, and (g) a subordination, nondisturbance, and attornment agreement from (i) _ _[*e.g., 100*]_ _ percent of the tenants leasing over _ _[*e.g., 10,000*]_ _ square feet and (ii) _ _[*e.g., 75*]_ _ percent of the tenants (by square footage) of the Property, all in form and substance satisfactory to Lender. Each lease described in the rent rolls submitted to Lender shall be in effect in accordance with its terms as of the date of such rent roll and there shall not exist any monetary or other material default under any such lease unless otherwise consented to in writing by Lender.

19. Enforceability Opinion of Counsel. Lender shall have received from Borrower's counsel or Lender's counsel a legal opinion in form and content satisfactory to Lender, and, if required by Lender, an opinion that the Borrower is a bankruptcy remote entity which is not at risk of having its assets substantively consolidated with those of another entity in the event of the bankruptcy or insolvency of any of Borrower's partners, members or principal shareholders, _ _[*or any Guarantor(s)*]_ _, or the affiliates of any of the foregoing.

20. No Material Adverse Change. Since the date of the Loan Commitment, there shall have been no material adverse change as determined by Lender in the financial condition or business of Borrower nor any material decline in the Property's value.

21. Formation of Borrower. Each of Borrower and Borrower's constituent entities shall conform to the formation and structure requirements of Lender, including the inclusion of any special purpose entity provisions within the formation documents of Borrower to the extent required by Lender.

Comment: On closing conditions, see §§2.4-2.6. If different standards will apply to the lender's approval of the closing conditions, this Exhibit B should be revised to delete the standard of approval from the introductory language and to add the appropriate approval standard to each applicable condition. Exhibit B should also identify any conditions already satisfied before issuance of the loan commitment and any specific requests from the borrower accepted by the lender.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/2 The Loan Commitment/§2.28 D. Form: Due Diligence Checklist

§2.28 D. Form: Due Diligence Checklist

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I. Title and Property Matters

- A. Preliminary report from a title company, together with copies of all of the underlying title documents
- B. ALTA survey meeting Lender's requirements (e.g., "as built," with required certification, etc.)
- C. Engineer's soil, structural, seismic, or environmental reports
- D. "As built" plans and specifications
- E. Construction contracts
- F. Certificates of Occupancy for improvements
- G. Zoning certificate (or zoning letter) issued by local governmental body, together with a copy of the zoning ordinance and any related resolutions, conditional use permit, etc. or alternatively, a zoning report in form and content satisfactory to Lender and prepared by a zoning consultant approved by Lender.
- H. Certified UCC searches issued within 30 days of the Closing, as follows*:

  1. Borrower:

  __ a. Secretary of State for state of formation of Borrower

  __ b. Secretary of State for state of principal place of business of Borrower

  __ c. Secretary of State for state where Property is located

  __ d. County where Property is located

  2. Managing member (or managing general partner) of Borrower:

  __ a. Secretary of State for state of formation of such entity

  __ b. Secretary of State for state of principal place of business of such entity

  __ c. Secretary of State for state where Property is located

  __ d. County where Property is located

  3. Each Guarantor and Indemnitor:

  __ a. Secretary of State for state of formation of such entity

  __ b. Secretary of State for state of principal place of business of such entity

  __ c. Secretary of State for state where Property is located

  __ d. County where Property is located

- I. Certified tax and judgment lien and litigation and bankruptcy searches issued within 30 days of the Closing, as follows:

  1. Borrower:

  __ a. Secretary of State for state of formation of Borrower

  __ b. Secretary of State for state where Property is located

__ c. Secretary of State for state of principal place of business of Borrower

__ d. County where Property is located and principal place of business of managing member

2. Managing member (or managing general partner) of Borrower:

__ a. Secretary of State for state of formation of such entity.

__ b. Secretary of State for state where Property is located

__ c. Secretary of State far state of principal place of business of such entity

__ d. County where Property is located

3. Each Guarantor and Indemnitor:

__ a. Secretary of State for state of formation of such entity

__ b. Secretary of State for state where Property is located

__ c. Secretary of State for state of principal place of business of such entity

__ d. County where Property is located and principal place or business/residence of guarantor and indemnitor

- J. Insurance policies, including receipt indicating that premium has been paid in full through _ _[*date*]_ _
- K. Tenant Estoppel Certificates issued within 30 days before Closing
- L. Subordination, nondisturbance, and attornment agreements
- M. Certified rent roll
- N. Copies of leases and other contracts, as applicable:
- 1. Commercial leases
- 2. Ground lease
- 3. Property management agreement
- 4. Third party service contracts
- 5. Franchise agreement

II. Entity Formation Documents and Authorization

- A. Formation documents for (a) Borrower, (b) managing member (or managing general partner) of Borrower, and (c) each Guarantor and Indemnitor:

1. If a limited liability company:

__ a. Articles of Organization (or Certificate of Formation) certified by the Secretary of State for state of formation, including all amendments; including SPE (single-purpose entity) provisions, if required

__ b. Operating Agreement, including all amendments

__ c. Evidence of qualification to do business in state where the Property is located

2. If a corporation:

__ a. Articles of Incorporation (Certificate of Incorporation) certified by the Secretary of State for state of incorporation, including all amendments; must include SPE (single-purpose entity) provisions, if required

__ b. Bylaws, including all amendments

__ c. Evidence of qualification to do business in state where the Property is located

3. If a limited partnership:

__ a. Certificate of Limited Partnership certified by the Secretary of State for the state where the Property is located, including all amendments

__ b. Partnership Agreement, including all amendments; must include SPE (single-purpose entity) provisions, if required

- B. Authorizing resolutions for (a) Borrower, (b) managing member (or managing general partner) of Borrower, and (c) each Guarantor and Indemnitor:
- 1. To enter into loan transaction
- 2. To execute loan documents to be executed by such party
- 3. Specifying which person(s) can bind the entity involved
- C. Good standing certificates for (a) Borrower, (b) managing member (or managing general partner) of Borrower, and (c) each Guarantor and indemnitor:
- 1. Issued by Secretary of State of state where entity was formed
- 2. Issued by Secretary of State of state where the Property is located
- D. Taxpayer ID of Borrower and of each Guarantor and Indemnitor (Form W-9)

III. Underwriting Matters

- A. Operating statements for the Property (current and at least three previous years)
- B. Certified balance sheet and financial statements for Borrower and each Guarantor and Indemnitor
- C. Credit reports on Borrower and each Guarantor and Indemnitor
- D. Appraisal of the Property
- E. Phase 1 environmental assessment report
- F. Architectural/engineering report
- G. Earthquake report

UCC filings made before July 1, 2001, when the revised Commercial Code Division 9 took effect, may be effective as late as June 30, 2006. Accordingly, UCC searches should include the places where UCC filings may have been made before July 1, 2001.

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3

The Promissory Note

Randy P. Orlik
Anthony Theophilos

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§3.1 I. SCOPE AND LIMIT OF CHAPTER

This chapter explains and analyzes the various elements of a promissory note secured by a deed of trust encumbering commercial property, and provides sample forms. Commercial notes are designed to adapt the basic promise to pay to the specifics of each transaction without the restrictions imposed on residential transactions. Promissory notes used in residential transactions (*i.e.,* the security is an owner-occupied dwelling of one to four residential units) are subject to a wide body of consumer-oriented state and federal law and are beyond the scope of this book.

To provide a starting point for a practitioner charged with the responsibility of drafting the note (typically, lender's counsel), a standard form note is set forth in §§3.59-3.78, with additional and alternative provisions in §§3.79-3.104. Borrower's counsel, however, is usually presented with an institutional lender's form note then in current use. The form may be subject to some negotiation and modification, but an institutional lender will rarely abandon its standard form for one prepared by borrower's counsel. In many instances, this apparent intransigence is not totally arbitrary, because some uniformity is necessary for the institutional lender to efficiently service the many loans originated each year and because it may wish to resell the note in a secondary market that requires standardization of form and content.

The secondary market for commercial loans is not subject to quite the same level of standardization as is that of the secondary market for residential mortgages. Nevertheless, many institutional lenders have programs by which they sell to other lenders either commercial loans in their entirety or participation interests in such loans (see §§1.18, 1.33, 1.90-1.107), retaining either a portion of the loans or the obligation to service the loans. Furthermore, the Federal National Mortgage Association (FNMA or "Fannie Mae") and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac") provide liquidity to residential mortgage lenders through their programs for purchasing mortgages on both 1-to-4-unit residences and large multifamily housing projects.

Fannie Mae has a corporate informational website that provides a variety of information on obtaining or refinancing a home mortgage, including a list of lenders who offer Fannie Mae loans, explanations of various mortgages, the mortgage process, and a calculation process to determine mortgage payments, interest rates, and down payments. Freddie Mac also offers a variety of information on its website address. For these websites, see the Directory.

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II. DISTINGUISH CONSTRUCTION FROM PERMANENT LOANS

§3.2 A. Construction Loans

Loans made to pay for the cost of improvements to be made on the real property that constitutes the security for the loan require considerably more documentation than do nonconstruction loans. With a construction loan, the lender must include in the loan agreement extensive controls over the overall cost of the improvements (*e.g.,* approval of the overall budget and changes to the plans and specifications, which could increase the cost of the project), as well as specific conditions precedent to the disbursement of the loan proceeds to pay the cost of materials and labor. Construction loans are discussed in chap 9.

It is important to understand how a construction loan differs from a permanent loan secured by real property. Specifically, construction loans have the following attributes:

- The lender must approve a construction budget and the plans and specifications for the proposed improvements (see §§9.4, 9.10).
- The maturity date is typically tied to the scheduled completion of the improvements. Completion is generally evidenced by the issuance of the appropriate occupancy permits or certification by the lender or the project architect that the improvements were completed in accordance with the plans and specifications previously approved by the lender (see §9.5).
- The lender disburses the loan proceeds periodically under the approved budget to pay the contractor and subcontractors for work completed during the last 30 days, subject to (1) certification by the lender or the project architect that the work was in fact completed in accordance with the plans and specifications that the lender previously approved, and (2) waiver by the contractor and subcontractors of their mechanics' lien rights to the extent they have received payment (see §9.23).
- The lender holds back a portion of the loan proceeds as a reserve to pay interest as it accrues until the improvements are completed and the project generates revenues sufficient to service the loan or a permanent loan is obtained from another lender. In other words, the construction lender pays itself interest from the loan proceeds (see §9.25).
- The lender will hold back 5 to 10 percent of the payments due the contractor (called the "retention") pending satisfactory lien-free completion of the improvements (see §9.28).
- Interest rates charged on construction loans are usually tied to the reference rate or some other commonly used benchmark rate or index (*e.g.,* the London Interbank Offered Rate (LIBOR), the average cost of funds of members of the Federal Home Loan Bank of the district in which the property or the lender is located, United States Treasury Securities adjusted to a constant maturity of a certain specified number of months or years, or the Federal Funds Rate). Thus, the interest rate on the note may fluctuate with an index during construction (see §9.13).

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§3.3 B. Permanent Loans

"Permanent" or "term" loans (*i.e.,* loans that are payable on demand or on a fixed maturity date and that are not construction loans) are typically made to repay a construction loan, refinance existing debt encumbering the property, or provide funds to a borrower to purchase a property. In some cases, a borrower may offer commercial real estate as security for a loan, the proceeds of which will be used for unrelated purposes. Historically, permanent loans were made by life insurance companies (or similar institutional lenders) for a term in excess of 5 years, with (1) interest accruing at a fixed rate (subject to a prepayment premium, as discussed in §3.32, if prepaid prior to maturity), (2) level debt service (*i.e.,* a fixed monthly payment that includes principal and interest) amortized over a longer period than the term of the note, and (3) a balloon payment due at the maturity of the note equal to the unpaid principal balance. Today, however, permanent loans can be structured in an almost unlimited number of ways, including the following:

- With terms ranging from 1 to 10 or more years;
- With interest rates either fixed or adjustable, and with the borrower permitted to choose the reference rate on adjustable rate notes (or to choose between fixed and adjustable rates) from time to time over the term of the loan (see §§3.11-3.13, 3.81); and
- With monthly payment of interest only and all principal due as a balloon payment on maturity, or principal payable in equal monthly installments together with interest accrued to date (see §§3.9, 3.85).

The alternative provisions in §§3.79-3.103 are designed to allow the practitioner flexibility in drafting a note to fit any structure appropriate to the transaction at hand.

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III. PRACTICAL AND LEGAL CONSIDERATIONS

A. Negotiability

§3.4 1. Personal Defenses; Statute of Limitations

Negotiability allows a third party to acquire a note from the original lender free of personal defenses that the borrower might otherwise have against the original lender. Thus, a holder-in-due-course takes a note free of personal defenses that the borrower might raise against the original lender in a collection action. Personal defenses include all defenses except an incapacity because of infancy, an incapacity that renders the transaction a nullity, duress, illegality, misrepresentation that induces the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms, discharge in insolvency proceedings, and any other discharge of which the holder has notice when the holder takes the instrument. Com C §§3305(a), 3601(b). Establishing the negotiability of a note may also significantly extend the applicable statute of limitations period from 4 years under CCP §337(1) to 6 years under Com C §3118. Assuming that the note has been taken for value, in good faith, and without notice of default or other irregularities in the note, a holder of a note has holder-in-due-course status if the holder acquires a negotiable instrument. Com C §3302(a).

On waiver of statute of limitations, see §4.41.

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§3.5 2. Writing

Under Division 3 of the California Uniform Commercial Code, a writing is defined to be a negotiable instrument only if it

- is payable to the bearer or to order at the time it is issued or first comes into a holder's possession;
- is payable on demand or at a definite time; and
- does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to payment of money.

The promise or order, however, may contain (a) an undertaking or power to give, maintain, or protect collateral to secure payment; (b) an authorization or power to the holder to confess judgment or realize on or dispose of collateral; or (c) a waiver of the benefit of any law intended for the advantage or protection of an obligor. Com C §3104(a).

Section 3104(a)(1) is satisfied by providing that the borrower promises to "pay to the order of _ _ _ _" or to "pay to _ _ _ _ or order" (see form in §3.60). The note could instead require that the borrower promise to pay "the bearer," although bearer notes are rarely used, because anyone with possession of the note may demand payment. Note, a "check" qualifies as a negotiable instrument even if not payable to bearer or to order. Com C §3104(c).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.6 3. Language

§3.6 3. Language

To be negotiable, the note must not (Com C §3106)

- contain a promise to pay that is subject to or governed by another document;
- contain an express condition to payment; or
- provide that the promise to pay is stated in another writing.

PRACTICE TIP: If negotiability is an important issue to the lender, counsel must satisfy Com C §3104(a), which provides that the note must (a) be payable to bearer or to order at the time it is issued, (b) be payable on demand or at a definite time, and (c) not state any other undertaking by the person promising to pay to do anything in addition to the payment of money. The note must not contain language suggesting that the promise to pay is conditioned on the occurrence of some event that is described in another document. A promise or order, however, is not made conditional (a) by a reference to another writing or statement of rights with respect to collateral, prepayment, or acceleration; or (b) because payment is limited to resort to a particular fund or source. Com C §3106(b).

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B. Drafting Considerations for Promissory Note

§3.7 1. Loan Commitment

If the borrower has previously received a loan commitment or an interest rate quotation, counsel should review it to ensure that the note and deed of trust comply with the terms of that loan commitment or rate quotation. It is important that there be no discrepancies between any loan commitment and the actual loan documents. On loan commitments generally, see chap 2.

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2. Timing and Mode of Payment

a. Equal Periodic Payments

§3.8 (1) Fully Amortizing Payments

The timing and mode of payment of a commercial note varies, depending on the nature of the transaction and the objectives of the parties. The traditional long-term fixed-rate loan provides for consecutive equal installments of principal and interest, fully amortizing principal over the term of the loan. The provision in §3.64 is an example of this format.

The note should contain a final maturity date to compensate for a miscalculation of regular installments or to pick up any odd amount generated by commencement or termination of the loan on a date other than the installment payment date. For discussion of amortization, see §1.28.

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§3.9 (2) Balloon Payments

Many loans with regular periodic installments are drafted to provide for a final, larger "balloon payment." In other words, the periodic payments of principal and interest (whether equal monthly payments or otherwise) do not fully amortize the loan unless a significantly larger final payment is made. In some instances, the installment payments are based on an amortization schedule several years longer than the period until maturity of the note. For example, a loan may provide for equal monthly payments of principal and interest sufficient to amortize the loan over 20 years, with all outstanding principal and interest due and payable at the end of the 10th year. For form, see §§3.84-3.85.

NOTE: On notes secured by owner-occupied 1-to-4-unit residences, the borrower must be given a notice stating the due date of a balloon payment at least 90 days before any action may be taken to enforce collection of that payment. CC §2924i. Civil Code §2966 imposes similar requirements on balloon payment notes given to the seller of a 1-to-4-unit dwelling in which there is an "arranger of credit," as defined in CC §2957.

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§3.10 b. Variable Payments

Variable payment provisions found in commercial notes are numerous and diverse, designed to fit the needs of the parties and the requirements of the particular business situation. A note with variable payments is any note in which regularly scheduled payments will vary (*e.g.,* month to month). It includes every form of regularly scheduled payment except equal consecutive payments. Variable payment provisions are found in notes with fixed interest rates as well as in notes with variable interest rates. It would be unusual, however, to see a long-term variable interest rate loan with a payment schedule of fixed equal installments of principal and interest for the term of the loan, because increases in the interest rate could result in significant negative amortization (*i.e.*, the regular installment payments might be insufficient to pay interest as it accrues, thus causing the outstanding debt to increase rather than decrease as payments are made).

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3. Variable Interest Rates

§3.11 a. Index Rate

Institutional lenders usually borrow the capital with which to make loans in markets where capital costs fluctuate over time. Before the 1970s, institutional real estate lenders often made long-term fixed-rate loans despite the costs of capital, which would fluctuate significantly over the term of the loan (*e.g.,* a savings and loan using demand or other short-term deposits to make 30-year residential loans). Today, lenders are more sensitive to changes in the short-term money market. Lenders may be forced to refinance their capital commitments fairly often and are thus subject to fluctuations in the money market. For that reason, loans are often tied to the reference rate (formerly called "prime rate") or some other commonly used benchmark. See form in §3.81. A variable interest rate provision allows the interest rate to fluctuate in accordance with changes in the short-term money market. The effect is to allow lenders to more closely match interest rates and maturities with capital costs, so that the lender takes less of a market risk and comes close to fixing a spread between the cost of funds and the charge for funds over the entire term of the loan.

Variable interest rate provisions allow the note's interest rate to fluctuate in response to changes in a reference rate called an "index," *i.e.*, it is the index that causes the interest rate to vary. The index is defined in such a way that it signals changes in the cost of money and to some extent the cost the lender must incur to obtain its funds. The variable rate provision in a commercial loan is not subject to the statutory and regulatory constraints imposed on such provisions in a residential real estate loan. See, *e.g.*, CC §1916.5; 12 CFR §560.35.

It is vital to carefully define the index to which the interest rate is tied and to specify precisely how the note's interest rate will vary with changes in value of the index. In this respect, simply using the term "reference rate" or "prime rate," as is often done, may be insufficient. To resolve this ambiguity, counsel should include an appropriate definition of the reference or prime rate. Fifteen or 20 years ago, lenders as a matter of practice defined the prime rate as "the rate charged to the most creditworthy borrowers for ninety-day unsecured loans." This language, however, created a problem because some "triple A" borrowers (*i.e.,* borrowers whose credit strength was graded AAA or its equivalent by credit rating services such as Moody's and Dun & Bradstreet) actually borrowed below the rates typically charged most creditworthy borrowers.

Owing to problems caused by the use and definition of the term "prime rate," most lenders today use the term "reference rate," which is often defined as an index for a variable interest rate which is quoted, published, or announced by the lender as its reference rate and as to which loans may be made by the lender, at, above, or below such rate.

The use of a variable rate by lenders not exempt from California's usury law presents additional drafting concerns (*e.g.*, setting a ceiling rate not exceeding the usury limits).

PRACTICE TIP: Practitioners representing nonexempt lenders should always confirm that the interest rate to be charged does not exceed the maximum permitted rate at the time the loan is made (see §3.41) or that the loan itself is exempt from usury (see §3.39). Prudence also dictates that lender's counsel include a "usury savings" clause when drafting a note to ensure that no violation of the usury law exists if any portion of the other consideration charged by the lender (such as points, commitment fees, etc.) are later characterized by a court as interest. See §§3.37-3.44.

Care must also be taken to consider an alternative index in the event the primary index should cease to exist. For example, an alternative would be needed if the index selected is a named bank's reference rate and the bank ceases business by merger or otherwise.

PRACTICE TIP: Most variable rate notes are drafted to provide that the annual interest rate shall equal "_ _[*number*]_ _ percent" in excess of the index. Although this language may be supportable through custom and usage, it is more accurate to say "_ _[*number*]_ _ percentage points" in excess of the index. Some lenders prefer to refer to "basis points" in excess of the index. Each basis point is 1/100 of a percentage point. For a provision

using the variable rate based on the reference rate, see §3.81.

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§3.12 b. Interest Rate Based on Contingency

A "contingent interest" provision is another type of variable interest rate provision found in shared appreciation loans. A "shared appreciation loan" is any real property secured loan that obligates the borrower to pay "contingent deferred interest" to the lender. CC §1917(b). Contingent deferred interest is defined as a share of (1) the appreciation in the value of the real property security for the loan, (2) rents and profits attributable to the real property security; or (3) both. CC §1917(a).

Contingent interest can take two forms: First, in a "participating" note, contingent interest allows the lender to earn as interest some portion of either a project's cash flow or the profit realized by the owner on the sale of the property (or refinancing or other specified event). Contingent interest in this form is exempt from the usury law. CC §1917.005. See §3.82 for a sample contingent interest provision. Interest on a participating loan can also be subject to a floor and a ceiling. In other words, the interest payable can be subject to a minimum and a maximum rate, regardless of the participating feature.

Second, contingent interest in a nonparticipating context can refer to an interest rate that changes on the occurrence of a specified event. By setting an interest rate that changes when a specified event occurs, the lender can offer a more attractive loan to a borrower acquiring a property when the revenue stream will increase rapidly after its acquisition, thus allowing the borrower to make interest payments that increase over time. For example, a borrower rehabilitating a shopping center may have a low cash flow during the initial stages of the project and a higher cash flow in subsequent years. The lender can meet the borrower's needs by setting an initially low interest rate with an increase scheduled when cash flow reaches a certain dollar amount.

More often, however, the interest rate does not increase on the occurrence of an event, but the "pay rate" changes. The pay rate is the actual cash payment of interest, which may be lower than the stated interest rate and the actual amount of accrued interest, resulting in an accrual of unpaid interest. Significantly, contingent interest in this form does not appear to be exempt from usury under CC §1917.005, because it does not meet the CC §1917(a) definition of "contingent deferred interest."

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§3.13 c. Variable Payments With Constant Interest Rate

In many situations, a lender will write loans with unequal monthly payments even though the interest rate remains constant. For form, see §3.85. A lender may also tailor the payment schedule to fit a borrower's particular needs. For example, a loan may be structured with monthly payments of accrued interest only for the first year of the term, increasing in the second, third, and fourth years to include growing principal amortization. The possible variations are almost infinite. See, *e.g.,* alternative 2 of form 3.83-1. Although installment payments are generally made on a monthly basis, they can be quarterly, semiannual, or on any other basis agreed to by the borrower and lender.

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§3.14 4. Calculation of Interest

There are essentially two methods for calculating interest. The "exact interest" method calculates interest based on a year of 365 days (366 days in a leap year). Mathematically, the interest due is calculated by dividing the annual interest due by 365 and multiplying the per diem interest by the actual number of days elapsed. If a note is silent on the method of calculating interest, the exact interest method must be used. See *Chern v Bank of America* (1976) 15 C3d 866, 127 CR 110.

The "banker's interest" method, calculated based on a year of 360 days, is calculated mathematically by dividing the annual interest due by 360 and multiplying the per diem interest by the number of days elapsed, which for a full year is 365. This method allows the lender to exact an additional five days in interest over a calendar year. If a loan is not otherwise exempt from usury laws, care must be taken when calculating interest based on the banker's interest method to avoid inadvertently exceeding the maximum permissible rate. See form in §3.63.

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5. Late Payment Charges

§3.15 a. Purpose of Late Charge

A late payment charge is an additional charge imposed by the lender when a payment is not made when due. It is often structured as a fee to cover the estimated cost of the additional servicing efforts of the lender, such as late notices and special processing. It may be exacted whether or not the lender decides to accelerate and foreclose on the security property. The late payment charge, however, generally does not cover the loss of economic return on the payment until received (*e.g.*, the lender's increased cost of funds). Thus many notes also provide for default interest on late payments until paid. See §3.36.

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§3.16 b. Validity of Late Charges

The validity of charging a borrower a fee if the borrower fails to make timely payments on the note has been extensively litigated in California, with a line of cases culminating in *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845. In *Garrett*, the California Supreme Court limited the type of late payment charges that could be assessed against a defaulting borrower. Specifically, the court analyzed late payment charges with respect to the economic costs to the lender and liquidated damages considerations, concluding that the late charges were invalid because they did not comply with the liquidated damages requirements of former CC §§1670-1671. At the time of the *Garrett* decision, former CC §1670 stated that a liquidated damages provision was void unless it satisfied CC §1671, which permitted the parties to agree on an amount in situations in which "it would be impracticable or extremely difficult to fix the actual damage." 9 C3d at 734 n1. Consequently, the *Garrett* court held that, contrary to §1671, the parties had not made a reasonable effort to estimate a fair average compensation for any loss that was sustained. Instead, the parties based their charge on a percentage of the unpaid balance rather than a percentage of the delinquent amount. The court was careful to note that not all late payment charges are in the nature of a penalty—only those that do not reflect a reasonable effort by the parties to fix a fair compensation in accordance with §1671. 9 C3d at 742.

After the *Garrett* decision, the legislature amended CC §§1670-1671 to modify the requirements for liquidated damages provisions in most situations, including commercial real property loans. A liquidated damages provision (*e.g.,* a late charge) is valid in a commercial real estate loan unless the borrower can establish that it was unreasonable under the circumstances existing at the time the loan was made. CC §1671(b).

NOTE: Civil Code §2954.4 provides specific statutory authority for a lender on a single-family residential property to impose a late charge of 6 percent or less of the installment due.

Although most often stated as a fixed percentage of the regular installment payment (or as a number of cents for each dollar of payment; see form in §3.66), the late payment charge can also be expressed as a fixed amount for each late payment.

NOTE: Property inspection fees imposed following a default to reimburse the lender for the actual cost of monitoring the condition of its security are not late charges within the meaning of CC §2954.4. *Walker v Countrywide Home Loans, Inc.* (2002) 98 CA4th 1158, 121 CR2d 79.

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§3.17 c. Assessment of Late Charges

If a note provides for a late payment charge, the period between the due date and the date on which the late charge accrues is deemed a grace period. *Baypoint Mortgage Corp. v Crest Premium Real Estate Inv. Retirement Trust* (1985) 168 CA3d 818, 214 CR 531. If one payment is made after the grace period expires but before the next payment is due, only one late charge may be collected. A late charge is collected only once for each late payment regardless of how much time elapses before the delinquent payment is made. For example, if the borrower fails consecutively to make six payments and then cures the default, the borrower must make all six payments plus six late charges.

If the borrower misses a payment one month, makes one payment in each of the following months, and then makes a double payment six months later to cure the default, the borrower owes six late charges, not one (assuming, as in commercial transactions, that each monthly payment is applied first to accrued interest). The single payment made in each succeeding month until the double payment was made, therefore, still leaves the borrower in arrears and subject to an additional late charge each month until the double payment is made to bring the loan current. The late charges that accrue are the same whether one payment is missed and cured six months later or whether no payments are made for six months and then six payments are made.

NOTE: With a loan secured by a single-family owner-occupied dwelling, the lender must apply any payment by the borrower to the most recently due payment. CC §2954.4. Only one late charge, therefore, would be due.

See *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378, for discussion of a clause combining elements of a late charge and a prepayment fee.

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6. Forbearance Not a Waiver; Extension; Partial Payments; Subordination

§3.18 a. Forbearance

The courts generally refuse to enforce a lender's rights if arguably the lender waived its rights by its own action or inaction. The provision in §3.73 anticipates this problem by stating that a waiver by the lender in the past is not to be construed as a waiver in the future. For example, a lender who has in the past accepted late payments without imposing a late charge or default interest is not barred from reassessing them in the future.

PRACTICE TIP: Despite the inclusion of a provision stating that forbearance is not a waiver or, if no such provision is included in the note, it is good practice for a lender to give written notice to a borrower who has made several late payments without imposition of a late charge or default interest, stating that the lender has elected to forgo imposition of such charges without waiving its rights to impose late charges in the future. Similarly, the lender may warn the borrower that any future late payments will be subject to late charges.

NOTE: If a note is given in consideration of a lender's agreement to forbear on or otherwise modify its exercise of remedies under a preexisting secured transaction, careful attention must be given to whether the transaction violates public policy as embodied in the foreclosure and antideficiency laws. For an example of this circumstance, see *Frangipani v Boecker* (1998) 64 CA4th 860, 75 CR2d 407. For additional discussion, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 5, 9 (4th ed Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.19 b. Modification; Extension

§3.19 b. Modification; Extension

If the secured property is subject to junior liens, a modification or an extension of the senior note may result in a loss of priority over those liens. In *Gluskin v Atlantic Sav. & Loan Ass'n* (1973) 32 CA3d 307, 108 CR 318, the plaintiff sold raw land for $400,000, taking back a $175,000 note secured by a first deed of trust on the property. The buyer then obtained two 30-year construction loans, totaling $3,500,000, to build homes on the property. The plaintiff subordinated its first deed of trust to the deed of trust securing the two construction loans. When the housing market soured, the buyer and the construction lender restructured the loans by reducing the principal on the larger loan from over $2,000,000 to $712,000, increasing the interest rate from 6.25 percent to 10 percent, and reducing the maturity date from 30 years to 10 months.

The construction lender later foreclosed on the property and obtained a judgment that its deed of trust was senior to the plaintiff's. The plaintiff appealed, and the court held that "a lender and a borrower may not bilaterally make a material modification in the loan to which the seller has subordinated, without the knowledge and consent of the seller to that modification, if the modification materially affects the seller's rights." 32 CA3d at 314. Having announced that rule, the court found that the plaintiff's deed of trust was senior to the construction lender's deed of trust.

After *Gluskin,* practitioners became concerned with modifying the terms of an obligation secured by a deed of trust, if there were junior liens, unless the junior lienholders executed a subordination agreement. Practitioners were concerned that any modification that was found to "materially affect" the rights of the junior lienor might result in the subordination of the senior lender's deed of trust to the junior lienor's. This fear was put somewhat to rest by *Lennar N.E. Partners v Buice* (1996) 49 CA4th 1576, 57 CR2d 435.

In *Lennar,* the Buice Revocable Living Trust acquired from Bank of America two notes secured by a first deed of trust on certain real property. The real property was subject to a second deed of trust, which was later acquired by Lennar Northeast Partners. Subsequently, and without obtaining the junior lienor's consent, the Buice Trust and the borrower amended the notes secured by the first deed of trust by modifying the term, the interest rate, and the principal amount owed. Based on these modifications and on *Gluskin,* Lennar argued that the deed of trust in favor of the Buice Trust was now subordinate to Lennar's deed of trust.

The appellate court held that merely extending the term of the loan was not by itself a material modification requiring an adjustment of priorities as a matter of law. Consequently, senior lenders are now generally comfortable with the fact that extending the terms of their loans, will not, by itself, affect the priority of their deeds of trust.

Two other modifications were made to the trust's loans: an interest rate change and an additional principal advance. The court held that, when a senior obligation is increased, whether by an increase in the interest rate or in the principal amount, it materially affects the junior lienor. The court did not agree with *Gluskin* that the appropriate remedy was a wholesale subordination of the senior deed of trust to the junior. Instead, the *Lennar* court found that the appropriate remedy was to subordinate the modifications to the junior deed of trust. Thus, the principal owed to the senior lender, when the modifications were made, accruing interest at the interest rate in effect before the modifications were made, continued to be secured by a deed of trust that was senior to the junior deed of trust.

The court in *Friery v Sutter Buttes Sav. Bank* (1998) 61 CA4th 869, 72 CR2d 32, also declined to extend the *Gluskin* remedy to a situation in which there was no subordination agreement. In *Lennar,* a subordination agreement had been executed, as part of an earlier workout, by the holder of the second deed of trust in favor of Bank of America. A subordination agreement was also at issue in *Gluskin*.

There was no subordination agreement at issue in the *Friery* case, in which the Frierys purchased property subject to a senior lien. They then sold the property, subject to the senior lien, and took back a deed of trust. The senior lienor declared an event of default, based on a due-on-sale clause. The property owner and the senior lienor executed an assumption agreement, which shortened the senior loan term by about 4½ years. Later, when the senior lender began foreclosure, the Frierys sued, alleging that the modification to the senior lender's loan (shortening the maturity date) meant that the senior lender's deed of trust should be subordinated to the Frierys' deed of trust.

The *Friery* court declined to extend *Gluskin* to this situation, which it characterized as involving a garden variety

junior lienor who had not executed a subordination agreement, bore no special relationship to the senior lender, and had no extraordinary facts in his favor that would warrant imposing on the senior lender a duty not to modify its loan without the junior's consent. The court noted that the Frierys voluntarily assumed a junior secured position, which they knew carried an element of risk. Renegotiation of the senior loan on transfer of ownership without the lender's consent was precisely one of the hazards that the Frierys accepted when they sold the property and took back a second deed of trust. The court never reached the issue of whether the modification materially affected the Frierys, finding that the senior lender had no duty to the Frierys.

PRACTICE TIP: Because of the *Lennar* and *Friery* cases, a senior lender may no longer risk having its entire loan subordinated if the loan is modified, even in the presence of junior liens. Nonetheless, because the California Supreme Court has not yet addressed this issue, prudence dictates that the senior lender obtain a subordination agreement from the junior lienors and an endorsement to its lender title insurance policy insuring the priority of its deed of trust when possible. On lender title insurance policies and endorsements, see California Title Insurance Practice, chaps 6, 8 (2d ed Cal CEB 1997).

On loan modifications and workouts generally, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 10 (4th ed Cal CEB 2009).

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§3.20 c. Partial Payments

A lender who has begun foreclosure proceedings should exercise care when accepting partial payment from the borrower by advising the borrower in writing that the lender's acceptance of the partial payment does not waive the default. See *Altman v McCollum* (1951) 107 CA2d Supp 847, 236 P2d 914. For further discussion of the relevant available title insurance endorsements to the lender's title policy that should be obtained, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.21 d. Subordination Agreements

§3.21 d. Subordination Agreements

By agreement of the parties, a subordination agreement changes the priority of liens that would otherwise be governed by the recording statutes. On recording statutes, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997). Subordination agreements (or subordination clauses) are generally used in two situations: first, when a lender insists on securing its loan with a first deed of trust and a recorded deed of trust already exists. Absent a subordination agreement, the second lender's deed of trust would be junior to the previously recorded deed of trust. In this situation, the borrower must obtain the agreement of the holder of the first deed of trust to subordinate the priority of its lien to the lien of the new deed of trust, which will secure the new loan. This commonly occurs when a buyer makes an installment purchase of unimproved real property for later development. The seller, who has taken back a deed of trust to secure the purchase price, is then asked to subordinate that deed of trust to the deed of trust securing a new construction loan.

Second, subordination agreements are commonly used when the parties decide to modify an existing loan. In *Lennar N.E. Partners v Buice* (1996) 49 CA4th 1576, 57 CR2d 435 (see §3.19), the senior lender, before selling the loan, had entered into an agreement with the borrower to restructure the loan. As part of this restructuring, the senior lender obtained a subordination agreement from the holder of the junior deed of trust to ensure that the first deed of trust, as modified, remained senior to the junior deed of trust.

When a seller of undeveloped real property provides the buyer with financing, buyer's counsel may want to require the seller to subordinate, in the future, the seller's deed of trust to a new deed of trust securing construction financing. Because at the time of the sale there is no construction financing, the seller should set forth the parameters of the construction loan to which it will be subordinate, such as the following:

- The maximum principal amount and term of the construction loan;
- The identity of the construction lender (*e.g.*, an institutional lender or other lender subject to the seller's approval);
- The use of the construction loan proceeds (*e.g.*, solely to construct the work of improvement on the encumbered property);
- The seller's right to approve the plans and specifications for the work of improvement;
- The maximum and minimum terms of the construction loan;
- The maximum interest rate (including points) of the construction loan;
- The amount of the monthly payments that must be made on the construction loan;
- The seller's right to approve the construction loan documents and any material amendments;
- The seller's right to cure the borrower's defaults on the construction loan; and
- The borrower's waiver of the antideficiency protection of CCP §580b (*Spangler v Memel* (1972) 7 C3d 603, 102 CR 807).

Of course, the construction lender wants the seller to agree to certain terms, such as the following:

- The construction loan will remain a lien on the property senior to the seller's deed of trust despite any modification, extension, or renewal;
- In making disbursements under the senior loan, the construction lender has no obligation to the seller to see to the proper application of the disbursements; and
- An endorsement will be placed on the seller's note, indicating that it is subordinate to the senior loan.

Obviously, there are conflicts between what the seller wants and what the senior lender wants. Most of these provisions are subject to negotiation, with the caveat that the senior lender may not make the loan if it does not receive the provisions it deems necessary.

Any subordinating lender must be careful that the terms of the executed subordination agreement conform to the terms under which the lender agreed to subordinate the priority of its deed of trust. In *Swiss Prop. Mgmt. Co. v*

Southern Cal. IBEW-NECA Pension Plan (1997) 60 CA4th 839, 70 CR2d 587, the court held that a subordination agreement signed by the seller, at the time a construction loan was made, was controlling, even though it did not meet the requirements for subordination in the seller's deed of trust.

For a more in-depth discussion of subordination agreements and clauses, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009).

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§3.22 7. Prepayment

California law has long allowed a lender to expressly prohibit prepayment of a debt before its due date. See *Smiddy v Grafton* (1912) 163 C 16, 124 P 433; *Rhorer v Bila* (1890) 83 C 51, 23 P 274; CC §1490. Without specific language in the note that permits prepayment, a borrower may not prepay the loan. A lender may agree in advance with the borrower on the consideration necessary for prepayment. See *Abbot v Stevens* (1955) 133 CA2d 242, 284 P2d 159; *McCarty v Mellinkoff* (1931) 118 CA 11, 4 P2d 595. Although lenders' prepayment rights are significantly mitigated by statutes and regulations covering residential loans (see, *e.g.*, CC §2954.9; Bus & P C §10242.6; Mil & V C §987; 24 CFR §207.253; 38 CFR §36.4310), commercial loans have few such limitations (although certain statutory requirements must be met to enforce prepayment fee provisions when a loan is accelerated under a due-on-transfer clause; CC §2954.10; see §3.31). See *Williams v Fassler* (1980) 110 CA3d 7, 167 CR 545. See also §3.24. For a waiver form, see §3.101.

Courts interpret notes that do not expressly give the borrower a right to prepay as contracts giving the lender bargained-for principal to be repaid over time, and not sooner. CC §1490; *McCarty v Mellinkoff, supra*. If a note payable in installments specifically provides for a fixed periodic sum "or more," however, the "or more" is interpreted to mean that prepayment is permitted. *Fugate v Cook* (1965) 236 CA2d 700, 46 CR 291; *Born v Koop* (1962) 200 CA2d 519, 19 CR 379.

NOTE: On loans secured by owner-occupied residential property of four or fewer units, sellers who takes back a secured deed of trust (but who do not take back four or more deeds of trust during the calendar year) may bar prepayment during the calendar year. CC §2954.9(a)(3). Prepayment charges are limited during the first 5 years of the loan and prohibited entirely thereafter. CC §2954.9.

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§3.23 a. Prepayment Privilege and Refinancing

A prepayment privilege clause allows a borrower to terminate all or a portion of its interest obligation to the lender before the final due date of the note by tendering part or all of the unpaid principal. If the loan is set at a fixed interest rate, a borrower who elects to pay off the loan during favorable monetary conditions is ostensibly in a "heads I win, tails I win" position, while the lender generally loses its most profitable loans and retains its least profitable ones. Theoretically, borrowers benefit from the privilege because they can refinance the loan if interest rates fall after the date of the note, but practical considerations often prevent borrowers from refinancing.

Although a new loan may have a lower interest rate, a new loan also involves front-end costs, *e.g.,* points, loan processing fees, appraisal fees, title insurance premiums. The front-end costs serve to increase the new loan's interest rate, and they must usually be paid in cash at the time the new loan is made, creating insurmountable cash-flow problems for many borrowers. Moreover, most loans with a prepayment privilege require the borrower to pay a charge to exercise that right. The prepayment charge further reduces the difference between the old and new interest rates, and the borrower usually finds the sum of new loan front-end costs and the old loan prepayment charge to be an effective barrier against refinancing. For prepayment forms, see §§3.90-3.93.

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b. Lock-In Provisions

§3.24 (1) Absolute Prepayment Prohibitions

Lenders need to ensure a long-term return on investments. To that end, a lock-in provision precludes prepayment of the note (including prepayment following default during the redemption period), while a phased lock-in provision permits the borrower to prepay only after a length of time that the lender considers sufficient to achieve its desired long-term objectives. It will also enable the lender to borrow longer term funds without the risk of repayment by the borrower, leaving the lender with a negative spread against the then-current interest rates. Conversely, the borrower will be unable to pay off or refinance the unpaid principal amount of the loan if the borrower's financial condition or current interest rates make it desirable to do so.

From the borrower's perspective, this provision could have a broader impact if the outstanding principal balance of the loan is substantially amortized, the value of the security property substantially appreciates, or both, during the period that the borrower has no right to prepay. If the deed of trust also prohibits junior encumbrances, the borrower is effectively precluded from cashing in this increased equity, even at a higher interest rate, by refinancing the existing loan or adding a second loan. Even if there is no due-on-sale clause and the borrower wishes to sell the encumbered property, the new buyer has no effective way to borrow a significant portion of the purchase price on a conventional basis, because the new buyer cannot offer the new lender the security of a first lien on the property. (Many institutional lenders are prohibited from making normal loan-to-value ratio loans except on the security of a first lien. See, *e.g.,* Fin C §§1223, 1227, 1235.)

Unless the new buyer is permitted and able to arrange second deed of trust financing (often at substantially higher interest rates), no sale will occur. Similarly, if the borrower needs additional capital, the borrower may have a large equity on which it cannot borrow.

As a practical matter, many institutional lenders allow prepayment during the lock-in period, but only if the borrower pays a substantial fee equal to or greater than the lender's then-positive spread (*i.e.,* the difference between the note's stated interest rate and the current market interest rate for similar loans). Even when the lender has a negative spread, it is not uncommon for the lender to demand a substantial fee for a waiver of the lock-in provision. Also, a note with a lock-in period usually provides for a specified prepayment penalty if there is an acceleration and prepayment during such lock-in period.

For form lock-in provisions, see §§3.88-3.89.

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§3.24A (2) Defeasance

Loans that contain absolute payoff restrictions sometimes permit defeasance of the loan as a means of allowing the borrower to dispose of the real property security free and clear of the deed of trust without violating the payoff restrictions. Defeasance is a complex procedure in which the loan is not actually paid off, but the real property securing the loan is replaced by substitute security. Because defeasance is most often required under "conduit" loans—loans that are pooled and sold to a qualified real estate mortgage investment conduit (REMIC) or other securitization vehicle—defeasance provisions must usually comply with strict REMIC restrictions under IRC §§860A-860G. On conduit financing and securitization, see §§1.18, 1.33, 1.90-1.107, and chap 10.

A defeasance provision typically contains at least three elements: (a) the borrower must provide U.S. Government securities as replacement collateral in an amount sufficient to generate cash for loan payments as and when due under the promissory note; (b) an independent accounting firm must verify that the collateral is sufficient to pay the promissory note in accordance with its terms; and (c) the loan must be assumed by an entity meeting strict single-purpose entity criteria. Because the cost of purchasing adequate U.S. Government securities to cover the loan payments is often far in excess of the loan balance, the difference is generally viewed as the equivalent to a prepayment or yield-maintenance premium paid as a consequence of a customary refinancing of a loan before its maturity date. On defeasance, see §§1.105, 10.21. For a sample form clause, see §10.30.

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§3.25 c. Validity of Prepayment Fee or Charge

In California, prepayment fees or charges are treated as an alternative performance to the contract rather than as liquidated damages. See *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 99 CR 417. Prepayment charges do not constitute liquidated damages and are not subject to the old dichotomy of *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845 (and of pre-1977 CC §§1670-1671), between unlawful penalties and lawful damages. *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 973, 73 CR2d 378. Nevertheless most lenders are leery of the term "penalty," preferring instead the terms "prepayment fee" or "prepayment charge." For further discussion of *Garrett,* see §3.16. See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 8 (4th ed Cal CEB 2009).

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§3.26 (1) Nondefault Prepayments

In *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 981, 73 CR2d 378, the supreme court invalidated prepayment charges (holding that they were actually late charges) when the negotiated language of the note provided that no prepayment charge would be assessed if all scheduled installment payments were timely made. The court reasoned that the condition of timely payment of interest installments "is logically unrelated to the charge's purported function as compensation for prepayment."

PRACTICE TIP: When lender's counsel is drafting a provision to permit prepayment, it is important to require that the prepayment be accompanied by interest accrued on the amount prepaid through the date of prepayment. See §3.91.

A court might also limit enforcement of a prepayment penalty it finds excessive. See *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 99 CR 417; *Hellbaum v Lytton Sav. & Loan Ass'n* (1969) 274 CA2d 456, 79 CR 9, overruled on other grounds in *Wellenkamp v Bank of America* (1978) 21 C3d 943, 953, 148 CR 379. A prepayment fee is not considered interest if the charge is reasonable and if the decision to prepay is at the sole option of the borrower. *French v Mortgage Guar. Co*. (1940) 16 C2d 26, 104 P2d 655; *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n, supra*. For further discussion of *Lazzareschi,* see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 8 (4th ed Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.27 (a) Involuntary Prepayments

§3.27 (a) Involuntary Prepayments

Borrower's counsel should try to negotiate language stating that there shall be no prepayment penalty for involuntary prepayments (*e.g.*, those arising from the application of insurance proceeds or a condemnation award).

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§3.28 (b) Partial Reconveyances

In deeds of trust containing partial reconveyance provisions, borrower's counsel should study the interaction of any lock-in or prepayment penalty in the note with the rights under the deed of trust to ensure that the partial reconveyances can be timely secured, and that, unless the parties so intend, no penalty attaches to the prepayment made to secure the partial reconveyances. Some lenders prefer to minimize or eliminate the additional administrative burden of dealing with partial prepayments by either prohibiting partial prepayments altogether or regulating when or in what amounts they may be made.

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§3.29 (c) Balloon Payments

In notes with a balloon payment, the prepayment charge cannot be significantly reduced by the balloon payment date; otherwise there may be a significant residual prepayment charge up to that date. This condition places the borrower in a difficult position because refinancing, if used, must coincide exactly with the due date. Because doing so is all but impossible, either because of economic conditions or the mechanics and timing of payments, borrower's counsel should try to negotiate a grace period, before the balloon payment date, in which there is either no prepayment charge or only a small residual charge.

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§3.30 (2) Prepayment on Default

Prepayment charges are not limited to voluntary prepayments. Courts have upheld imposition of prepayment charges following the lender's acceleration of the note on the borrower's default. *Biancalana v Fleming* (1996) 45 CA4th 698, 53 CR2d 47 (if prepayment charge is inapplicable, obligor could render clause meaningless by intentionally defaulting to provoke acceleration and then offering amount due minus prepayment charge). See Bernhardt, *Prepayment Pitfalls*, 19 CEB Real Prop L Rep 181 (Aug. 1996).

In *Pacific Trust Co. TTEE v Fidelity Fed. Sav. & Loan Ass'n* (1986) 184 CA3d 817, 229 CR 269, the junior lienholder paid the senior lien and the prepayment penalty before the property was sold at the trustee's sale. The court rejected the junior lienor's argument that the prepayment penalty constituted invalid liquidated damages under CC §1671 on the ground that federal regulations controlled.

In *Golden Forest Props. v Columbia Sav. & Loan Ass'n* (1988) 202 CA3d 193, 248 CR 316, the junior lienor did not redeem the property before the trustee's sale but acquired the property at the sale. The bid included a prepayment penalty assessed by the senior lienor. The junior lienor argued that the prepayment penalty applied only to the trustor or junior lienor who redeemed the property before it was sold at auction and that it was inapplicable if the property was sold at a trustee's sale. The *Golden Forest* court, citing *Pacific Trust*, found that the intent of the loan documents was clearly to permit a prepayment penalty. In dictum, the court held that the imposition of a prepayment penalty was not limited to the trustor or its successor in interest. Anyone buying the property at the trustee's sale would have been required to pay the penalty to defeat the beneficiary's full credit bid, which properly included the prepayment penalty. 202 CA3d at 199.

See also *Trident Ctr. v Connecticut Gen. Life Ins. Co.* (9th Cir 1988) 847 F2d 564.

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§3.31 d. Prepayment on Transfer

Civil Code §2954.10 prohibits the collection of a prepayment penalty resulting from an acceleration of a loan secured by a mortgage or deed of trust on residential real property containing four or fewer units arising from the conveyance of any right, title, or interest in that property. Section 2954.10 states that it does not apply to any loan other than a loan secured by residential real property containing four or fewer units in which the obligor has expressly waived, in writing, the right to prepay, in whole or in part without penalty, or has expressly agreed, in writing, to the payment of a penalty on acceleration. Section 2954.10 also states that "for any loan executed on or after January 1, 1984, this waiver or agreement shall be separately signed or initialed by the obligor and its enforcement shall be supported by evidence of a course of conduct by the obligee of individual weight to the consideration in that transaction for the waiver or agreement." See §3.101 for form language.

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§3.32 e. Calculation of Prepayment Charge

The prepayment charge may constitute a specified percentage of the amount of prepaid principal. The reduction of such specified percentage over time is quite common.

Some lenders charge a prepayment fee based on the greater of (1) a specified percentage of the prepaid principal amount or (2) the "loss of yield" for the prepaid principal amount based on a specified formula or index. There are many different methods for determining loss of yield, most of which are quite complex. One of the simplest methods is based on the average "Treasury Constant Maturity" percentage for the term most equal to the number of years then remaining in the term of the note for the week preceding the week during which the prepayment occurs. This index is calculated by the United States Treasury and is published in document H.15 (519) issued by the Board of Governors of the Federal Reserve System, titled "Federal Reserve Statistical Release." See Directory for website.

Using this simple method of calculating a prepayment charge, the "loss of yield" is calculated by multiplying the positive difference, if any, obtained by subtracting the index rate from the note rate by the following:

- The amount of prepaid principal;
- One twelfth (1/12); and
- The number of months remaining in the term of the note.

EXAMPLE: Assume that a loan with a $100,000 outstanding principal balance matures in 5 years and bears interest at 9 percent. Assume that the borrower prepays this loan and that the Treasury Constant Maturity is 8 percent. Using the method described above, subtracting the Treasury Constant Maturity from the note rate yields 1 percent. One percent of $100,000 is $1000, divided by 12 is $83.33, which when multiplied by 60 (5 years equals 60 months) yields a prepayment fee of $5000.

Few prepayment fee calculations are this simple. They usually require the use of computers to calculate the present value of an interest rate spread over the remaining term of the loan.

The index rates used are typically lower than the note rates. A lender might want to create a more reasonable representation of loss of yield by subtracting the current index rate from the rate in effect when the loan was negotiated. Lack of a reasonable estimate of loss of yield may prevent the lender from collecting a prepayment fee. See *In re Skyler Ridge* (Bankr CD Cal 1987) 80 BR 500 (decided on basis of prepayment fee being liquidated damages).

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§3.33 f. Payoff Demand

Civil Code §2943 requires that, on the borrower's written demand, a lender must deliver a payoff demand statement to the borrower, setting forth the amount required to fully satisfy all obligations under the note. The borrower is entitled to rely on this statement in establishing the amount necessary to pay the note in full. The lender, however, has an unsecured claim against the borrower if the lender delivers an understated payoff demand. CC §2943(d)(3). For a more detailed discussion of understated payoff demands, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 5, 8 (4th ed Cal CEB 2009).

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§3.34 g. Order of Application of Payments

The note should clearly specify the order of application of principal prepayments. See form in §3.94. In some cases the lender is willing to accept a prepayment and forgo the next scheduled principal payment, while in other cases the lender looks to the scheduled principal payments in order of maturity, especially in notes requiring a balloon payment. On lender's obligation to deliver payoff demand, see §3.33.

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§3.35 8. Acceleration on Default and Reinstatement

A provision in a note allowing for acceleration of the debt on default (*i.e.*, either failure to make a payment on the note when due or failure to timely comply with any other term or provision of the note, the deed of trust, or any other collateral document) is essential as a condition precedent to the lender's right to exercise its remedies. An acceleration clause may be included in the note without affecting its negotiability. Com C §§3104(a)(2), 3108(b)(2). For a sample provision, see §3.65.

In the event of a default and the commencement of foreclosure of the deed of trust securing the note, the borrower has certain reinstatement rights. CC §2924c(a). Reinstatement is the borrower's right to make up any past-due payment, together with certain costs incurred by the lender. Reinstatement is permitted, depending on whether the lender is foreclosing nonjudicially or judicially, either up until 5 business days before the date of the trustee's sale or until entry of the decree of foreclosure in a judicial foreclosure. CC §2924c. On reinstatement rights, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 2 (4th ed Cal CEB 2009).

PRACTICE TIP: In representing a borrower, it is always prudent to negotiate a provision granting the borrower a grace period after receipt of notice before the lender may declare the note in default if the borrower fails to make a payment when due. The existence of statutory reinstatement rights is often relied on by lenders as justification for not including a grace period. Borrower's counsel, however, can counter that position by arguing that both a grace period *and* notice should be required if a payment is lost. Otherwise, a premature declaration of default could subject the borrower to statutory costs under CC §2924d. Real property reinstatement rights will not prevent a foreclosure on personal property absent the lender's decision to conduct a "unified" foreclosure of both real and personal property under Com C §9604(a). If the lender agrees to a grace period, lender's counsel should make sure that the deed of trust does not require a *second* grace period before foreclosure proceedings can be initiated. *Florio v Lau* (1998) 68 CA4th 637, 80 CR2d 409. On unified foreclosure of real and personal property collateral, see Mortgage Deed of Trust Foreclosure, chap 9.

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§3.36 9. Default Interest

A default interest clause provides additional compensation to a lender in a default. Some default interest provisions increase interest on the entire outstanding amount if there is a default in payment. See, *e.g.,* the provision in §3.67. The same concerns about late-payment charges in *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845, may apply in this context, and, pending some additional judicial clarification, there is no assurance that such a provision will withstand a *Garrett*-type attack. The default interest provision may be void under *Garrett* principles because it imposes an increased interest rate even on amounts not in default. On *Garrett*, see §3.16. It would be a safer course of action to provide for higher interest only on delinquent amounts or on acceleration of the entire indebtedness.

PRACTICE TIP: Counsel must take care to ensure that the default rate of interest does not exceed any applicable usury limitations. If the lender is not an exempt lender, it is important to always include the maximum rate permitted by law limitation.

Whether a secured lender is entitled to its default rate of interest in a bankruptcy context was addressed by the Ninth Circuit Court of Appeals in *In re Entz-White Lumber & Supply, Inc.* (*Great W. Bank & Trust v Entz-White Lumber & Supply, Inc.*) (9th Cir 1988) 850 F2d 1338. *Entz-White* holds that when a debtor cures a defaulted loan under a confirmed plan of reorganization, either by paying the entire loan amount immediately if the loan matured without acceleration before filing or by tendering the past-due amounts in one or more installment payments if the loan was accelerated as a result of a default, all consequences of the default, including contractual higher postdefault interest rates, are avoided. However, a bankruptcy court in the Second Circuit has held that the *Entz-White* rule "is no longer justified or warranted" following the 1994 enactment of 11 USC §1322(e). *In re Adejobi* (Bankr ED NY 2009) 404 BR 78, 81. The *Adejobi* court states that under the "plain language" of §1322(e), the amount necessary to cure a default is the same as would be required under the original agreement if the debtor were not in bankruptcy. *In re Adejobi, supra*. The court continued (*Adejobi,* 404 BR at 83):

> The general rule in bankruptcy is that contractual interest on a debtor's obligation accrues up to the date of the bankruptcy filing. If unpaid, all contractually accrued interest, including default interest, becomes an integral component of a creditor's claim in bankruptcy.

It will be interesting to see the Ninth Circuit response to *Adejobi* if, and when, the issue of default interest comes before it.

Note that when the debtor's plan of reorganization proposes to extend the matured loan for a period after confirmation of the plan, one Ninth Circuit court has already determined that the *Entz-White* rule does not apply. See *In re Tri-Growth Centre City, Ltd*. (*Imperial Bank v Tri-Growth Centre City, Ltd*.) (Bankr SD Cal 1992) 136 BR 848.

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§3.37 10. Usury

California's usury law, set forth in Cal Const art XV, §1, provides that for any loan or forbearance (whether of money, goods, or other things in action) if the proceeds are primarily for personal, family, or household use, the maximum permissible annual interest rate is 10 percent per annum. Any loan or forbearance of any money, goods, or other things in action, the proceeds of which are used primarily for the purchase, construction, or improvement of real property, are not considered to be used primarily for personal, family, or household purposes. Cal Const art XV, §1(1). The maximum permissible annual interest rate for loans (or forbearances of any money, goods, or other things in action) used for nonpersonal, family, or household purposes is the higher of 10 percent or 5 percentage points over the rate established by the Federal Reserve Bank of San Francisco on advances to member banks. On date for calculating maximum interest rate, see §3.41.

PRACTICE TIP: The federal discount rate can be determined for any particular date by contacting the Federal Reserve Board. See Directory.

For usury laws to apply, the transaction must be a loan or forbearance. *Ghirardo v Antonioli* (1994) 8 C4th 791, 795, 35 CR2d 418; *Southwest Concrete Prods. v Gosh Constr. Corp.* (1990) 51 C3d 701, 705, 274 CR 404. A credit sale is not subject to usury, because it does not involve a loan or forbearance. 8 C4th at 803; *Southwest Concrete Prods. v Gosh Constr. Corp., supra*.

The use of the loan proceeds at the time the loan is being made decides whether a loan is a personal or nonpersonal loan. If the lender does not control how the proceeds are to be disbursed (*e.g.*, as a means of ensuring that the proceeds will be used to purchase real property), lender's counsel may want to include in the note an express representation from the borrower as to the intended use of the loan proceeds and an agreement by the borrower not to use the proceeds for any other purpose. For form, see §3.102. Estoppel is a defense to a charge of usury if the lender relies on such representation of the borrower. *Buck v Dahlgren* (1972) 23 CA3d 779, 100 CR 462.

For further discussion of usury, see Lind, *A Real Estate Attorney's Guide to California Usury Laws*, 18 CEB Real Prop L Rep 271 (Oct. 1995).

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§3.38 a. Definition of Interest

For usury purposes, any compensation received by a lender from a borrower is interest unless it falls into one of the categories of charges that courts have found to be permitted as additional compensation for the lender's services. The following is a brief discussion of certain types of charges—some are considered interest and others are not:

- **Points, bonuses, and origination fees.** Points, bonuses, and origination fees will not be characterized as interest for usury purposes if the charges are (1) directly related to actual costs incurred by the lender; (2) those usually and customarily incurred in this type of transaction; and (3) for services rendered by someone other than the lender's in-house employees. See *Forte v Nolfi* (1972) 25 CA3d 656, 102 CR 455. Although a lender may charge a flat fee instead of itemizing actual costs, any excess received by the lender above costs actually incurred will be treated as interest. See *Cambridge Dev. Co. v U.S. Fin.* (1970) 11 CA3d 1025, 90 CR 333. Payment to the lender's agent by a broker will be considered interest if made with the consent of the lender or later ratified by the lender.
- **Commitment fees.** Fees charged by a lender for its commitment to fund a loan at borrower's election are not interest but are a charge to compensate the lender for holding this money available for the period of the commitment. *Gonzales County Sav. & Loan Ass'n v Freeman* (Tex 1976) 534 SW2d 903; *D & M Dev. Co. v Sherwood & Roberts, Inc.* (Idaho 1969) 457 P2d 439.
- **Contingent interest.** When the lender receives a flat rate of interest plus additional contingent interest to be collected only if the project is profitable, the courts will hold that the contingent interest is not usurious if the parties contracted in good faith and without intent to evade the usury laws. See, *e.g.*, *McConnell v Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1978) 21 C3d 365, 375, 146 CR 371 (citing *Arneill Ranch v Petit* (1976) 64 CA3d 277, 134 CR 456). Lenders are exempt from the usury provisions of the California Constitution with respect to shared appreciation loans as defined in CC §1917(b). CC §1917.005.
- **Compound interest.** Although compound interest is permissible, it is usurious if, by compounding it more often than annually, it results in the lender's receiving interest exceeding the maximum permitted rate. *Heald v Friis-Hansen* (1959) 52 C2d 834, 345 P2d 457. A savings clause, however, may evidence the parties' intent not to evade usury laws and, by applying excess interest to principal, reduce the interest rate to the highest legal amount. *In re Dominguez* (Smith v Miller) (Bankr 9th Cir 1993) 995 F2d 883.
- **Prepayment fees.** Prepayment fees are not considered interest if the charge is reasonable and if the decision to prepay is at the borrower's sole option. *French v Mortgage Guar. Co.* (1940) 16 C2d 26, 104 P2d 655; *Lazzareschi Inv. Co. v San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 99 CR 417.
- **Late charges.** *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845, held that a late charge was in the nature of liquidated damages and was not considered interest. See also *First Am. Title Ins. & Trust Co. v Cook* (1970) 12 CA3d 592, 90 CR 645. It is still possible, however, for the exaction of a late charge to be treated as merely a sham to evade the usury laws. For statutory limitations on late charges in certain cases, see CC §2954.4. See also *Home Sav. & Loan Ass'n v Superior Court* (1976) 54 CA3d 208, 126 CR 511.
- **Interest on credit sales.** A seller of property may sell it for whatever price and on whatever terms he or she wishes, without violating the usury law. A seller may agree to sell the property at one price for cash and for a different price if the price is paid over an extended period of time. This concept is known as the "time price" doctrine. Thus, a credit sale, when the seller provides the buyer part or all of the financing, is not subject to the usury law, because the sale does not involve a loan or forbearance of money. *Ghirardo v Antonioli* (1994) 8 C4th 791, 35 CR2d 418; *Boerner v Colwell Co.* (1978) 21 C3d 37, 145 CR 380.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.39 b. List of Exemptions

§3.39 b. List of Exemptions

The following is a list of certain constitutional and statutory exemptions to California's usury law.

Exemptions	Authority
1. California chartered banks	Cal Const art XV, §1
2. California savings and loan associations	Cal Const art XV, §1
3. Licensed personal property brokers	Cal Const art XV, §1
4. Incorporated credit unions	Cal Const art XV, §1
5. Nonprofit agricultural, horticultural, or dairy cooperative associations and certain other agricultural corporations	Cal Const art XV, §1
6. Licensed pawnbrokers	Cal Const art XV, §1
7. Licensed industrial loan companies	Cal Const art XV, §1
8. Loans or forbearances made or arranged by a licensed real estate broker and secured by liens on real property	Cal Const art XV, §1 CC §1916.1
9. National banks	Cal Const art XV, §1
10. Federal intermediate credit banks	Cal Const art XV, §1
11. Any successor-in-interest to any loan or forbearance exempted in 1 through 10 above	Cal Const art XV, §1
12. Federal and state savings and loan associations, savings banks or associations, and their subsidiaries and holding companies	Fin C §7675
13. Foreign state banks	Fin C §§1716, 3805
14. Certain licensed foreign banks and foreign banks with assets greater than $100,000,000	Fin C §1716
15. State or federal associations and service corporations authorized to exercise trust powers and acting in fiduciary capacity as trustee	Fin C §6515
16. Trust companies and state and national banks acting in fiduciary capacities	Fin C §1504
17. Bank holding companies and subsidiaries	Fin C §3707
18. Licensed brokers and industrial development corporations	Fin C §31410
19. Consumer finance loans made by a licensed finance lender	Fin C §22203
20. Commercial finance loans made by a licensed finance lender	Fin C §22502
21. Loans made by college-level educational institutions to students (specified interest rate caps)	Fin C §28000
22. Loans made by college-level educational institutions to faculty or staff and secured by residential dwellings	Fin C §28000(c)
23. Admitted, incorporated insurers	Ins C §1100.1
24. Physicians and surgeons' cooperative indemnity corporations	Ins C §1280.7(a)(4)

25. Evidence of indebtedness qualified under Chapters 2 or 3 of Corporations Code (issuer transactions; recapitalizations and reorganization)	Corp C §25116
26. Investment grade evidence of indebtedness	Corp C §25117
27. Certain commercial loans; certain commercial loans guaranteed by an affiliate of borrower	Corp C §25118
28. Transactions conducted by licensed broker-dealers	Corp C §25211.5
29. Out-of-state public pension systems	CC §1916.2
30. Pension funds/retirement systems subject to the Employee Retirement Income Security Act (ERISA) (see Warning below)	CC §1917.220
31. Shared appreciation loans	CC §1917.005
32. Shared appreciation loans to seniors	CC §1917.616
33. Common-interest development associations	CC §1366(e)
34. Bottomry contracts	Harb & N C §455
35. Certain public bond issues	Govt C §5906
36. California state and local public retirement systems	Govt C §7509
37. Federally related, first lien, residential real property loans	12 USC §1735f-7a
38. Farm credit systems	12 USC §§2001, 2016
39. Small business investment companies	15 USC §687(i)
40. Small Business Administration development company debentures	15 USC §697
41. National banking associations extended "most favored lender" status	12 USC §85
42. VA loans extended protection of National Housing Act (12 USC §1735f-7a)	38 USC §3728

WARNING: The exemption from the usury law in CC §1917.220 for pension funds and retirement systems governed by ERISA is preempted by ERISA. *Varr v Olimpia* (1996) 45 CA4th 675, 53 CR2d 106; *In re Seolas* (Seolas v LH Research, Inc. Profit Sharing Plan) (ED Cal 1992) 140 BR 266. *Seolas* also held, however, that ERISA does not preempt the general usury law and that those pension plans are therefore subject to the constitutional limitations on usury.

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§3.40 c. Loans Made or Arranged by Brokers

Most commercial lenders are exempt from the usury law. For nonexempt lenders, Cal Const art XV, §1 exempts loans that are made or arranged by licensed real estate brokers who are licensed by the California Department of Real Estate and that are secured, directly or collaterally, by liens on real property. CC §1916.1. The phrase "made or arranged" includes any loan made or arranged by a person licensed as a real estate broker as a principal or as an agent for others, whether or not the person is acting within the course and scope of such license. CC §1916.1. Although a broker does not have to be acting within the course and scope of a broker's license to come within the exemption, it appears that, to fall within the exemption for loans "arranged" by a broker, the broker must be acting for compensation or in the expectation of compensation. CC §1916.1; *Jones v Kallman* (1988) 199 CA3d 131, 244 CR 609; *In re Lara* (9th Cir 1984) 731 F2d 1455. See also *Stickel v Harris* (1987) 196 CA3d 575, 242 CR 88, holding that a broker's interest in the borrowing entity for which the broker arranged the loan is sufficient to meet the requirement that the broker must be acting in expectation of compensation.

PRACTICE TIP: If the lender is relying on this usury exemption, lender's counsel should obtain a certificate signed by the broker stating that the broker arranged the loan for compensation. The certificate should include the broker's license number.

For more on mortgage loan brokers, see §§1.4-1.7; California Real Estate Brokers: Law and Litigation, chap 8 (Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.40A d. Certain Commercial Loan Exemptions

§3.40A d. Certain Commercial Loan Exemptions

Two usury exemptions for certain commercial loans can be found in Corp C §25118. First, §25118(a) provides that a loan to an entity that has total assets of at least $2,000,000, according to its most recent financial statement (prepared either in accordance with GAAP (Generally Accepted Accounting Principles) or in accordance with the rules and requirements of the Securities Exchange Commission) and which loan transaction meets certain other criteria set forth in §25118, is exempt from California usury laws. This exemption also applies to loans that are guaranteed by an affiliate of the borrower that meets the foregoing total assets test. Second, under §25118(b), loans aggregating at least $300,000 in original face amount at the time of issuance and loans made under a written commitment for the lending of at least $300,000 are also exempt from the California usury laws, provided such loans meet certain other criteria set forth in §25118.

Neither of these Corp C §25118 usury exemptions applies to loans made or guaranteed by individuals, a revocable trust having one or more individuals as trustors, or partnerships in which, at the time of issuance, one or more individuals are general partners. Corp C §25118(e)(1). In addition, the §25118 exemptions do not apply unless (1) the lender and borrower (or guarantor) have a preexisting personal or business relationship, or (2) the lender and borrower (or guarantor), by reason of their own business and financial experience or that of their professional advisers, can reasonably be assumed to have the capacity to protect their own interests in connection with the loan transactions. Corp C §25118(f).

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§3.41 e. Date for Determining Applicable Maximum Interest Rate

The maximum permissible rate for a commercial real property loan is determined on the 25th day of the month preceding the earlier of (1) the date of execution of the contract to make the loan or (2) the date the loan is made. If a loan commitment is complete, details all the material terms, and contains an obligation on both parties' behalf to consummate the transaction, the commitment date should be the relevant rate-setting date for purposes of determining the maximum permissible interest rate for that loan. In other cases, the relevant rate-setting date should be the date of execution of the first document that creates a binding agreement on both parties to consummate the transaction (*i.e.*, the loan documents).

The maximum rate calculated for a particular loan at its inception remains the maximum permissible rate throughout the term of that loan. *First Am. Title Ins. & Trust Co. v Cook* (1970) 12 CA3d 592, 596, 90 CR 645. Consequently, if interest rates fall over time (including federal discount rates) it is possible to have a variable rate loan whose current interest rate is higher than the maximum permissible rate for a loan originating at a later time.

PRACTICE TIP: When lender's counsel is presented with a situation in which the client and the borrower have agreed on an interest rate that is otherwise usurious (and the lender is not an exempt lender), before finalizing the loan documents and funding the loan, counsel should consider the following questions, which may provide a method to resolve the problem:

- If a licensed real estate broker was involved in the transaction, can it be established that the broker "arranged" the loan? See §3.40.
- Can the lender's economic objectives be realized by restructuring the note as a participating note? See §3.12. In the alternative, can the note be split in two, with one bearing interest at a nonusurious rate and the second as a participating note?
- Are there sufficient contacts and interests in another state to justify a choice-of-law provision establishing that state's law as the governing law? See §3.43.
- Does the loan qualify as an exemption under Fin C §22064 as either (1) a program-related investment made by a private foundation, tax-exempt organization; or (2) a loan, guaranty, or investment made by a public charity, tax-exempt organization? (Note that these exemptions apply only through January 1, 2010, unless extended by law.)
- Can the nonexempt lender apply for and receive a finance lender license under the California Finance Lenders Law (Fin C §§22000-22780) to convert its status to that of an exempt lender? The lender-applicant will have to furnish a full set of fingerprints and related information to assist in the mandatory background check of the lender. Fin C §22101(b). Does the lender have enough time to convert its status to that of a nonexempt lender? The principal requirements for obtaining a license are (Fin C §§22100-22112):
- Net worth of at least $25,000;
- Satisfactory background check of principal officers, directors, and persons owning or controlling ten percent or more of the outstanding interests or equity securities; and
- Payment of $300 in application and investigation fees.

With any of these alternatives, it is crucial to include a usury savings clause. See §3.44.

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§3.42 f. Successor Holders

If a loan is exempt from usury at the time it is made, it remains exempt even if it is later acquired by another lender, even a nonexempt lender. *Strike v Trans-West Discount Corp.* (1979) 92 CA3d 735, 155 CR 132. This statement is not true, however, if the parties structure the loan in a manner solely to evade the usury laws. *Anderson v Lee* (1951) 103 CA2d 24, 228 P2d 613. For an approved transaction, see *Boerner v Colwell Co.* (1978) 21 C3d 37, 145 CR 380.

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§3.43 g. Choice-of-Law Considerations; Waiver

In certain circumstances, California's usury law can be avoided with a choice-of-law provision in the note establishing the law of a state other than California as the law governing the note. It is crucial, however, that the selected state has sufficient contacts and interests in the transaction to justify the application of such state's law. Compare *Shannon-Vail Five, Inc. v Bunch* (9th Cir 2001) 270 F3d 1207, upholding a loan by applying Nevada law to a loan from Nevada lenders to California corporations and secured by California real estate, and *Ury v Jewelers Acceptance Corp.* (1964) 227 CA2d 11, 38 CR 376, upholding a contract made and performed in New York, with *Rochester Capitol Leasing Corp. v K & L Litho Corp.* (1970) 13 CA3d 697, 91 CR 827, applying California law, rather than the law of the lender's domicile, to invalidate a transaction as usurious. See discussion of usury and conflict of laws in 1 Witkin, Summary of California Law, *Contracts* §88 (10th ed 2005).

The following constitute the required contacts and interests in another state:

- Either the borrower, the lender, or both is domiciled in that state;
- The lender disburses the loan proceeds in that state;
- A formal closing is conducted in that state with all parties present;
- The documents provide for payments to be made to the lender in that state;
- The documents provide for the application of the laws of that state; and
- Negotiations are conducted in that state.

See *Mencor Enters., Inc. v Hets Equities Corp.* (1987) 190 CA3d 432, 235 CR 464, to the effect that a choice of law in the usury area is still available if the chosen forum has significant contacts with the transaction. See also *Committee of Unsecured Creditors v RG Fin. (In re Powerburst Corp.)* (Bankr ED Cal 1993) 154 BR 307.

PRACTICE TIP: If counsel is attempting to establish the governing law of a state other than California, it is important to include in the note or other loan documentation recitals confirming the applicable contacts and interests.

California's usury law is designed to protect borrowers from lenders who wish to receive a higher interest rate than permitted. Thus, even if the borrower knows that the loan violates the usury law, that knowledge would not prevent the borrower from later suing the lender for having made a usurious loan. Nor does the voluntary payment by a borrower of usurious interest constitute a waiver of the usury laws. *Heald v Friis-Hansen* (1959) 52 C2d 834, 345 P2d 457; *Buck v Dahlgren* (1972) 23 CA3d 779, 100 CR 462; *Baruch Inv. Co. v Huntoon* (1967) 257 CA2d 485, 65 CR 131.

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§3.44 h. Usury Savings Clause

An essential element of usury is the lender's intent to receive interest in excess of the maximum permitted. *North v Cecil B. De Mille Prods.* (1934) 2 C2d 55, 39 P2d 199; *Thomassen v Carr* (1967) 250 CA2d 341, 58 CR 297. The requisite intent is absent if the excessive interest rate is the result of a mistake. Mistake of law, however, is insufficient as a defense to a claim of usury. A lender who intends to receive the interest provided in the agreement, but does not realize that that interest exceeds the amount permitted by the usury law, is still liable for usury. *Thomas v Hunt Mfg. Corp.* (1954) 42 C2d 734, 269 P2d 12; *Shirely v Britt* (1957) 152 CA2d 666, 313 P2d 875.

It is common, in many loan agreements, to find a usury savings clause. Such a clause states that, if for any reason the interest rate provided in the agreement is in excess of that permitted by the usury law, the rate will be adjusted downward so that the usury law is not violated. For form, see §3.76.

The savings clause is intended to show the lender's good faith intent not to violate the usury laws by providing for a reduction of the principal balance to correct any collection of interest or other charges later found to be usurious. Such good faith intent may be a defense to an unintentional usury law violation. *McConnell v Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1978) 21 C3d 365, 146 CR 371.

A usury savings clause, by itself, will not save a transaction that is clearly usurious on its face. A savings clause may, however, be evidence that the lender's requisite intent was missing, and, therefore, the loan is not usurious. *Arneill Ranch v Petit* (1976) 64 CA3d 277, 134 CR 456; *Lakeview Meadows Ranch v Bintliff* (1973) 36 CA3d 418, 111 CR 414; *In re Dominguez (Smith v Miller)* (Bankr 9th Cir 1993) 995 F2d 883.

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§3.45 11. Attorney Fees

Unless authorized either by statute or agreement, attorney fees are seldom recoverable. CCP §1021; *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 158 CR 1. Thus, a lender will be able to recover its attorney fees only if the note or deed of trust so provides. Any attorney fee clause should require payment of attorney fees actually incurred and other costs of collection whether or not suit is filed. See form in §3.69. Civil Code §1717(a) requires that, if a contract provides for attorney fees to be awarded to any party, the prevailing party, whether or not entitled to attorney fees by the contract, is entitled to attorney fees. California courts are divided on whether to uphold the application of CC §1717 to unilateral attorney fee clauses in contracts containing foreign choice-of-law provisions and in which the foreign law permits enforcement of unilateral attorney fee provisions. Compare *ABF Capital Corp. v Grove Props. Co.* (2005) 126 CA4th 204, 23 CR3d 803 (upholding a unilateral fee provision) with *ABF Capital Corp. v Berglass* (2005) 130 CA4th 825, 30 CR3d 588 (rejecting a unilateral fee provision). Thus, there is no advantage in attempting to draft a clause benefiting just one party. The prevailing party is determined by the court, whether or not the suit proceeds to final judgment. CC §1717(b)(1). Nevertheless, there is no prevailing party for the purposes of awarding attorney fees if an action on the note is voluntarily dismissed or dismissed in a settlement of the case. CC §1717(b)(2).

Code of Civil Procedure §685.040 provides that attorney fees incurred in enforcing a judgment are collectible as long as the underlying judgment includes an award for attorney fees to the judgment creditor under CCP §1033.5(a)(10)(A) (attorney fees authorized by contract). This statute explicitly overrules *Chelios v Kaye* (1990) 219 CA3d 75, 268 CR 38, which prohibited the award of attorney fees in enforcing a judgment even though the underlying contract provided for such an award. The court in *Miller v Givens* (1994) 30 CA4th 18, 37 CR2d 1, permitted the assignee of a judgment creditor to recover attorney fees incurred after the effective date of the amendment of CCP §685.040 to enforce a judgment awarded before the 1992 amendment of §685.040 (which overruled *Chelios*). The court held that, because the fees were incurred after the amendments to the statute became effective, the application of amended §685.040 was not retroactive.

For discussion of enforceability of an attorney fee clause after an action is voluntarily dismissed, and for a review of cases discussing the acceptable scope of attorney fees and cost awards, see §§6.23-6.25.

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§3.46 12. Waiver of Presentment, Notice of Dishonor, and Protest

Under California commercial law, a note holder who transfers it to another by endorsement agrees to pay the note according to the note's terms (*i.e.*, if the borrower does not make payments as specified in the note), unless the endorsement specifies otherwise. Com C §3415. The endorser (the original holder), however, may have its obligations discharged if the present holder (the subsequent purchaser) of a note fails to make a timely presentment (*i.e.*, a demand for payment of the note) or provide a timely notice of dishonor (*i.e.*, an informal notice given in any reasonable manner) or protest (*i.e.*, a formal certificate of dishonor) on the borrower's default. Com C §§3501-3505. To prevent a discharge of the originating lender on a mere technicality, most notes require the original borrower and all endorsers to waive their rights to presentment, notice of dishonor, and protest, as permitted by Com C §3504. Some notes also include express waivers of diligence in collection and enforcement, demand, and nonpayment of the note, as well as requiring that all waivers be made by all sureties and guarantors. An endorser who guarantees payment does not automatically waive presentment, notice of dishonor, protest, or demand on the maker. Com C §§3419, 3503. For form of waiver, see §3.70.

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§3.47 13. Joint and Several Liability

Although all comakers of a note may be jointly and severally liable, to avoid any potential claim that liability is limited to prorata ownership of the encumbered property, lenders generally require an affirmation of the comakers' joint and several liability. See form in §3.80.

PRACTICE TIP: Counsel should not include sureties or guarantors as comakers of the note. This dual capacity may give the guarantor access to defenses available to the borrower that are typically waived in a guaranty agreement and are thus normally not available to the guarantor or that generally are available only to the borrower, such as one-action and antideficiency protections. *Component Sys. Corp. v Eighth Judicial Dist. Court* (Nev 1985) 692 P2d 1296. The point is that the dual capacity may give the surety or guarantor access to rights or defenses that would otherwise be unavailable.

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§3.48 14. Governing Law

The state whose laws will apply to the note will generally be apparent. In some instances (*e.g.*, a lender from one domicile, a borrower from another domicile, and encumbered real property in yet another domicile), serious choice-of-law questions arise, many of which can be resolved if the parties clearly specify a choice of law. As noted in §3.43, however, using the law of one jurisdiction to avoid the usury limitations of another may not override conflict-of-laws principles or public policy considerations.

Conversely, if an applicable federal law is more advantageous and would ordinarily preempt state law, counsel must be careful not to preclude its application. In this event, the optional language in form 3.75-1 can be used.

In *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330, the California Supreme Court approved the proposition that, *in general*, parties to a multistate contract may, by so stipulating in their contract, choose the law of one of the states with which such contract has a substantial relationship to govern their rights and obligations under the contract. The supreme court held that "[i]n determining the enforceability of arm's length contractual choice-of-law provisions, California courts shall apply the principles set forth in [Restatement (Second) of Conflict of Laws §187 (1971)], which reflects a strong policy favoring enforcement of such provisions." 3 C4th at 464. See also *Hambrecht & Quist Venture Partners v American Med. Int'l, Inc.* (1995) 38 CA4th 1532, 46 CR2d 33.

Unfortunately, certain decisions of the Court of Appeal before *Nedlloyd* have created uncertainty in the determination of whether the chosen jurisdiction's relationship to a transaction is "substantial," and these decisions were not expressly overruled in *Nedlloyd*. See *Mencor Enters., Inc. v Hets Equities Corp.* (1987) 190 CA3d 432, 235 CR 464; *Ashland Chem. Co. v Provence* (1982) 129 CA3d 790, 181 CR 340.

Section 187 of the Restatement (Second) of Conflict of Laws (1971) provides that a choice-of-law provision does not have to be followed if application of the law of the chosen state would be contrary to a fundamental policy of a state that has a materially greater interest than the chosen state in determining the particular issue. This means that California courts may ignore a choice-of-law provision if they determine that the law of the chosen state differs from the fundamental policy of California law and that California has a greater interest in applying its law to the case at hand. See *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 72 CR2d 73.

One choice-of-law case, concerning the application of CCP §580b, illustrates the importance of specific facts in determining the efficacy of a particular choice-of-law provision. In *Guardian Sav. & Loan Ass'n v MD Assocs.* (1998) 64 CA4th 309, 75 CR2d 151, based on factors such as the parties' domicile and their degree of sophistication, the court upheld application of Texas law to a California foreclosure so as to preclude application of §580b, despite a ruling by the court that §580b embodies a "fundamental policy" of California law.

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§3.49 15. Nonrecourse

A nonrecourse provision states that the borrower has no personal liability and limits the lender's sources of recovery in a default. Under such a provision, if the value of the secured property on its sale is insufficient to cover the outstanding obligation at the time of default, the lender may not seek a deficiency judgment to recover the difference from the personal assets of the borrower. In essence, a nonrecourse provision eliminates the primary reason for a lender to pursue judicial foreclosure (which usually permits a deficiency judgment), and, as a practical matter, limits the lender to nonjudicial foreclosure (which does not permit a deficiency judgment).

California law provides some nonrecourse protection whether or not such a provision is in the note. The one-action rule of CCP §726 precludes a mortgagee from obtaining a deficiency judgment by ignoring its security and suing directly on the obligation. The antideficiency provisions of CCP §§580b and 580d, respectively, generally preclude deficiency judgments on:

- A seller's purchase money note or a third party lender's purchase money loan to a borrower who acquires an owner-occupied 1-to-4-unit residence, secured in whole or in part by a mortgage or deed of trust on the property purchased; or
- Any debt secured by a mortgage or deed of trust that is foreclosed nonjudicially.

The antideficiency protection provided by these statutes is not absolute. Antideficiency statutes do not protect a borrower who fraudulently induced the lender to make the loan. Likewise, an action for damages for fraud is not a deficiency judgment and is not barred by the antideficiency statutes. See Fin C §779 (applicable to loans made by a state or nationally chartered bank); CCP §726(f) (applicable to loans made or arranged by a licensed real estate broker); *In re King St. Inv.* (*Hardin v Gianni)* (Bankr 9th Cir 1998) 219 BR 848. Nor does a lender's full credit bid on properties at a nonjudicial foreclosure sale preclude the lender's action for fraud against third parties in inducing the lender to make the loans. *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352.

A full credit bid may, however, bar the lender from maintaining a *negligence* action against a third party. See *Pacific Inland Bank v Ainsworth* (1995) 41 CA4th 277, 48 CR2d 489, distinguishing *Alliance Mortgage* on the basis that it applied only to a fraud action. But see *Kolodge v Boyd* (2001) 88 CA4th 349, 105 CR2d 749 (rejecting reasoning of *Pacific Island Bank* on grounds that antideficiency statutes do not require limiting *Alliance Mortgage Co.* holding to fraud actions), and *In re King St. Inv. (Hardin v Gianni), supra,* in which the Bankruptcy Appellate Panel disagreed with and declined to follow *Pacific Inland Bank*, holding that it incorrectly applied *Alliance Mortgage* and noting that the California Supreme Court had not expressly passed on this issue. For a complete discussion of antideficiency statutes, fraud, and full credit bids, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5 (4th ed Cal CEB 2009).

PRACTICE TIP: Borrowers entering into contractually nonrecourse or limited recourse transactions with institutional lenders must make certain that the exculpatory language is included in the note or deed of trust (or in a core loan document executed with the note and trust deed). Putting nonrecourse or exculpatory language in side letters or similar documents will create a serious risk of avoidance if the lending institution or a successor holder fails. See *RTC Mortgage Trust v Shlens* (1998) 62 CA4th 304, 72 CR2d 581 (applying *D'Oench, Duhme & Co. v FDIC* (1942) 315 US 447, 86 L Ed 956, 62 S Ct 676).

For form disclaimer of personal liability, see §3.97.

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§3.50 a. Tax Considerations of Nonrecourse Financing

If the borrower is a limited partnership, income tax considerations probably require that an express disclaimer of personal liability be included in the note. One reason to use a limited partnership vehicle is to permit the depreciation benefits available under the income tax laws to be allocated directly to the individual limited partners. If the borrower is a limited liability company, such an express disclaimer might not be necessary for tax purposes; however, if a member of the limited liability company has agreed to recourse covenants relating to the loan, such an express disclaimer might be prudent as well. The benefits of pass-through treatment of losses to partners in general, to limited partnerships, and to members of limited liability companies are not available to shareholders of corporations. Even S corporations, which provide general pass-through treatment for corporate income and loss items, are seldom used to hold leveraged assets because the shareholders do not generally obtain a tax basis in their stock for debt borrowed at the corporate level. IRC §§1366(d), 1367.

By contrast, partners in partnerships and members of limited liability companies generally obtain so-called outside bases for debt borrowed at the entity level (IRC §752), which permits partners and members to have enough basis to absorb depreciation that is attributable to borrowed funds. How an entity-level liability is allocated among the partners or members depends on whether it is recourse or nonrecourse. Reg §§1.752-1—1.752-3. If a debt is recourse, it may be allocated among only the partners who are personally liable for its repayment; if it is nonrecourse, it may be allocated among all partners or members, on the basis that any economic loss suffered from a decline in the value of the secured asset below the amount of the debt will be borne, not by a partner or member, but by the lender.

Another reason to structure the loan without personal liability is that in order for nonrecourse financing to be "qualified nonrecourse" financing, and thus qualify as an amount with respect to which a taxpayer is considered to be "at risk," no one may be personally liable for its repayment. IRC §465(b)(6)(B)(iii).

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§3.51 b. Limitations on Nonrecourse Provisions

Most lenders limit the disclaimer of personal liability of the borrower under the note. See form in §3.97. For example, the disclaimer may be modified to add language making it applicable "except in the event of (a) fraud or (b) any material misrepresentation made to the Holder in connection with this Note." Such limiting factors (also called "carveouts") are not unreasonable; but if the borrower is a limited partnership, they may jeopardize the limited partners' being able to include their share of the partnership liabilities in their partnership basis. See tax considerations in §3.50.

Other common exceptions are for "misapplication" of rents, security deposits, insurance or condemnation proceeds, commission of waste, failure to obtain and maintain in effect the insurance policies required under the loan documents, and the cost of remediation of any hazardous substances on the property. Some lenders also attempt to include a variation of the following as an exception: "Any breach of any covenant in the deed of trust or other agreements securing this note other than the covenant to pay the indebtedness due under this note." Such a broad clause should be resisted by the borrower.

Attorney fees may need to be separately addressed for actions based on nonrecourse carveouts. See, *e.g.*, *Aozora Bank, Ltd. v 1333 North Cal. Blvd.* (2004) 119 CA4th 1291, 1296, 15 CR3d 340.

The borrower should also negotiate for the right to apply rents to the costs of operating the property, including payment of any debt service, without generating liability. The borrower should negotiate to end personal liability for hazardous substances once the borrower no longer has title to the property. Exceptions to a disclaimer of personal liability are very common and run the range of lender's counsel's imagination and, depending on how aggressive the lender is, are sometimes heavily negotiated.

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§3.52 16. Cross-Default

Often a lender who makes a loan secured by a junior deed of trust includes, as an event of default under its loan, the occurrence of default under the senior deed of trust. A lender with a junior deed of trust does not want to be in a position of having its loan kept current while the senior deed of trust is in foreclosure. In fact, it is common that a default under any senior lien encumbrance (including real property taxes) constitutes a default under the loan.

When a borrower has more than one loan with a lender, the lender may insist on a cross-default provision because it does not want to maintain a lending relationship with a borrower who keeps some loans current while others are in default. Perhaps as important to lenders, the ability to call all the borrower's loans may put additional pressure on a borrower to keep payments current on an unsuccessful project that the borrower might otherwise abandon, forcing the lender to foreclose on the property. The cross-default provision, especially if the borrower does substantially all its business with one lender, can effectively result in one bad project bringing down the borrower's entire empire, regardless of purchase money protection or private sale antideficiency legislation. The cross-default provision is typically included in the loan document defining "Default" or "Event of Default" with specificity. It can be added, however, to the note if the drafter so desires; see form in §3.98.

PRACTICE TIP: The default provisions of many standard form deeds of trust also list certain events that constitute a default under the deed of trust and that allow the lender to accelerate the loan and foreclose if the borrower fails to pay debts as they fall due. If a borrower successfully negotiates to avoid an absolute cross-default provision, borrower's counsel must also carefully examine the deed of trust to ensure that it contains no such contradictory provision.

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§3.53 17. Waiver of Statute of Limitations

The 4-year statute of limitations on actions to enforce written obligations is a personal defense and may be waived. *California First Bank v Braden* (1989) 216 CA3d 672, 264 CR 820; *Steiner v Croonquist* (1951) 108 CA2d Supp 895, 238 P2d 690. The waiver is not perpetual, however; it simply extends the ordinary limitation period by 4 years, although successive waivers may be executed. CCP §360.5. The waiver must be in writing and signed by the person waiving the defense.

For discussion of the impact of the running of the statute of limitations on the underlying obligation on the foreclosure rights of lender as beneficiary under a deed of trust, see §4.41. For form, see §3.99.

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§3.54 18. Severability

The usefulness and enforceability of a severability provision may depend on the particular provisions that are held to be invalid and the impact of that invalidity on the note's remaining provisions. The severability of provisions is a question of construction to be determined by a court based on the parties' intention. *Birbrower, Montalbano, Condon & Frank, P.C. v Superior Court* (1998) 17 C4th 119, 70 CR2d 304; *Keene v Harling* (1964) 61 C2d 318, 38 CR 513; *Conrad v Thompson* (1955) 137 CA2d 73, 290 P2d 36. For form, see §3.100. Although most notes and deeds of trust contain a severability provision, there may be occasions when a party does not want such a provision.

EXAMPLE: If a particular transaction would not have been entered into absent a specific condition, the parties may not want the transaction to continue if that condition is later invalidated. This situation can be dealt with either by eliminating the severability provision or by modifying it to provide that if a certain provision is invalidated the contract is also invalidated.

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§3.55 19. Time of the Essence

If it is important to the lender that loan payments be made on time, it is imperative that a provision that time is of the essence be included. See *Bisno v Sax* (1959) 175 CA2d 714, 721, 346 P2d 814. Even if the note contains such a provision, however, a court may be reluctant to allow a lender to enforce its rights for minor delays in payment. See *Baypoint Mortgage Corp. v Crest Premium Real Estate Inv. Retirement Trust* (1985) 168 CA3d 818, 214 CR 531 (late payment during grace period cannot be deemed a default). For form, see §3.77.

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IV. SIMPLE FIXED INTEREST PROMISSORY NOTE

§3.56 A. Drafting Assumptions

Section 3.57 sets forth a simple fixed interest rate note. This sample promissory note does not comply with all requirements of all agencies empowered to regulate or insure a given type of loan or to purchase loans in a secondary market (see discussion in §3.1). See Warning in §3.58.

The sample clauses are written under the assumption that the borrower is a limited liability company, that payment of the promissory note is secured by real property located in California, and that California laws otherwise apply. If part or all of the property lies outside of California, or if a choice-of-law provision invokes the law of another jurisdiction, it may be necessary to augment the provisions of this sample note.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.57 B. Form: Simple Promissory Note

§3.57 B. Form: Simple Promissory Note

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3.57-1 Simple promissory note

PROMISSORY NOTE SECURED BY DEED OF TRUST

_ _[*Dollar amount*]_ _ _ _[*Date*]_ _

The undersigned, _ _[*name*]_ _ (Borrower), promises to pay to _ _[*name*]_ _, or order (Lender), the principal sum of _ _[*dollar amount*]_ _ dollars ($_ _[*dollar amount*]_ _), together with interest on the unpaid principal balance from time to time outstanding at an annual rate of _ _[*number*]_ _ percent (_ _[*number*]_ _%), with all principal and interest due and payable on _ _[*date*]_ _ (the Maturity Date).

This Note shall be subject to the following additional provisions:

1. Security. This Note is secured by, among other things, that certain Deed of Trust, Assignment of Leases and Rents, Fixture Filing, and Security Agreement (the Deed of Trust) of even date herewith made by Borrower, as trustor, for the benefit of Lender, as beneficiary.

2. Prepayment. This Note may be prepaid, at any time, in whole or in part, without premium or penalty, as long as any principal prepayment is accompanied by a payment of interest accrued to the date of prepayment on the amount prepaid.

3. Application of Payments. Each payment under this Note shall be credited first to interest then due and any remainder to principal. All payments of principal under this Note shall be applied to the most remote principal installment then unpaid.

4. Default. On (a) Borrower's failure to pay any sum due under this Note when it becomes due and payable, (b) the occurrence of an Event of Default under the Deed of Trust, or (c) any breach of any other promise or obligation in this Note or in any other instrument now or after this date securing the indebtedness evidenced in this Note (collectively, a Default), then, and in any of such event, Lender may, at its option, declare this Note (including, without limitation, all accrued interest) to be immediately due and payable, regardless of its Maturity Date. Borrower expressly waives notice of the exercise of this option.

5. Costs of Collection. If this Note is not paid when due, whether on the Maturity Date or on acceleration of this Note, Borrower promises to pay all collection costs, including, but not limited to, attorney fees and court costs, whether or not suit is filed on this Note.

6. Waiver of Presentment. Borrower and all persons liable or to become liable on this Note waive presentment, protest, and demand; notice of protest, demand, and dishonor; and any and all other notices or matters of a like nature.

7. Default Rate of Interest. On the occurrence of a Default under this Note, the entire unpaid principal balance shall then automatically bear interest at an annual rate equal to the lesser of (a) _ _[*number*]_ _ percent (_ _[*number*]_ _%) per annum or (b) the maximum interest rate allowed by law (the Default Rate).

8. Governing Law. This Note shall be governed by and construed in accordance with the laws of the State of California.

9. Usury. All agreements between Borrower and Lender are expressly limited, so that in no event or contingency, whether because of the advancement of the proceeds of this Note, acceleration of maturity of the unpaid principal balance, or otherwise, shall the amount paid or agreed to be paid to Lender for the use,

forbearance, or retention of the money to be advanced under this Note exceed the highest lawful rate permissible under applicable usury laws. If, under any circumstances, fulfillment of any provision of this Note or the Deed of Trust securing this Note or any other agreement pertaining to this Note, after timely performance of such provision is due, shall involve exceeding the limit of validity prescribed by law that a court of competent jurisdiction deems applicable, then, ipso facto, the obligations to be fulfilled shall be reduced to the limit of such validity. If under any circumstances, Lender shall ever receive as interest an amount that exceeds the highest lawful rate, the amount that would be excessive interest shall be applied to reduce the unpaid principal balance under this Note and not to pay interest, or, if such excessive interest exceeds the unpaid principal balance under this Note, such excess shall be refunded to Borrower. This provision shall control every other provision of all agreements between Borrower and Lender.

10. Time Is of the Essence. Time is of the essence with respect to all obligations of Borrower under this Note.

IN WITNESS WHEREOF, Borrower has executed this Promissory Note Secured by Deed of Trust as of the date first written above.

Borrower

Date: _ _ _ _ _ _ _ _[*Name of limited liability company*]_ _**, a California limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: In many situations, a short and simple note will suffice. This form provides for interest to accrue at a fixed rate and with all principal and interest due on maturity and permits prepayment at any time. The provisions in this form are the minimum that should be included in any note, no matter how simple or straightforward the loan.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.58 V. COMMERCIAL PROMISSORY NOTE SECURED BY DEED OF TRUST

§3.58 V. COMMERCIAL PROMISSORY NOTE SECURED BY DEED OF TRUST

Sections 3.59-3.78 set forth general provisions that one could include in a typical commercial loan note. Some of these provisions can be replaced or modified by including the additional or alternative provisions in §§3.79-3.103.

WARNING: The sample promissory note provisions in §§3.59-3.103 do not comply with all requirements of all agencies empowered to regulate or insure a given type of loan or to purchase loans in a secondary market (see discussion in §3.1). These requirements may change with some regularity, depending on the demands of the marketplace. Counsel should scrutinize relevant state and federal regulations, as well as the requirements of the appropriate private or public loan insurers or secondary market purchasers concerning the transaction at hand before proceeding.

The sample commercial promissory note provisions assume that the borrower is a limited liability company, the promissory note is secured by real property located in California, and the laws of California otherwise apply. If part or all of the property is outside of California, or if a choice-of-law provision invokes the law of another jurisdiction, it may be necessary to add provisions to this sample note.

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§3.59 A. Form: Caption

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3.59-1 Caption

PROMISSORY NOTE SECURED BY DEED OF TRUST

_ _[*Dollar amount*]_ _ _ _[*Date*]_ _

_ _[*Address*]_ _**, California**

Comment: Virtually all notes state the principal balance in the upper left-hand corner under the "Promissory Note" heading, and state the date in the right-hand corner. Some forms include the city or county and state in which the note was executed. There is, however, no legal requirement for these elements. They are included primarily for ease of reference.

The date is material if the note states that interest begins to accrue from the date of the note. As a rule, the note is executed before the date that the loan is funded, with interest to accrue from the date funds are advanced. One mechanism for dealing with this is to leave the date blank at the time of execution and to instruct the escrow holder (if there is a loan escrow) to insert the closing date before delivering the note to the lender. An alternative approach is to state in the note that interest begins to accrue from the date of recordation of the deed of trust that secures the note.

If the borrower is an out-of-state entity or individual, including the city or county and state may be helpful as evidence that the note was executed in California. Although not dispositive of the issue, it would probably create a presumption of execution in California if a conflict-of-laws issue is ever raised.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.60 B. Form: Promise to Pay: Place of Payment

§3.60 B. Form: Promise to Pay: Place of Payment

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3.60-1 Promise to pay: place of payment

FOR VALUE RECEIVED, the undersigned, _ _[*name*]_ _, a California _ _[*e.g., limited liability company*]_ _ (Borrower), hereby promises to pay to _ _[*name*]_ _, or order (Lender), the principal sum of _ _[*dollar amount*]_ _ dollars ($_ _[*dollar amount*]_ _), together with interest on the

[*Add one of the following alternatives*]

[*Alternative 1: Principal advanced at once*]

unpaid principal balance of this Note

[*Alternative 2: Principal advanced in installments*]

amount of principal actually advanced and outstanding on this Note

[*Continue*]

from time to time outstanding at an annual rate as set forth below from the date of advance until fully paid at _ _[*address*]_ _, or at such other place as Lender may from time to time designate in writing.

Comment: The first paragraph of every note usually identifies the borrower (sometimes identified as the "payor" or the "maker"), the lender (sometimes identified as the "payee" or the "holder"), and the total sum borrowed.

The entire principal amount of a permanent (term) loan has usually been advanced at the time the executed note is delivered to the lender, often through a loan escrow (alternative 1). If the loan is not fully funded as of execution and delivery, the note (and the separate loan agreement, if any) should state that interest will accrue only on the amount actually advanced and outstanding from time to time (alternative 2). If interest is to accrue on the unpaid principal, whether or not it has been disbursed, this language will need to be modified. For form alternative methods of payment of principal and interest, see §§3.83-3.87. On amortizing and balloon payments, see §§3.8-3.9.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.61 C. Form: Interest

§3.61 C. Form: Interest

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3.61-1 Interest

1. Interest. Interest on the unpaid principal balance will accrue from the date of advance at an annual rate equal to _ _[*number*]_ _ percent (_ _[*number*]_ _%).

Comment: This provision is used with a simple fixed rate of interest. For other methods of calculating interest, such as interest based on the reference rate, see §§3.81-3.83.

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§3.62 D. Form: Payment

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3.61-1 Payment

2. Payment. All sums due under this Note are payable in lawful money of the United States. Checks constitute payment only when collected.

Comment: This provision makes it clear that all payments must be in United States dollars (helpful if the borrower is a non-U.S. person or entity). This provision also makes it clear that checks constitute payment only when collected—not delivered.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.63 E. Form: Method of Calculating Interest

§3.63 E. Form: Method of Calculating Interest

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3.63-1 Method of calculating interest

3. Method of Calculating Interest. Interest shall be computed based on a 360-day year and the actual number of days elapsed. Interest computed based on a 360-day year is greater than interest computed based on a 365-day year.

Comment: In commercial loans, lenders generally include this type of provision, which allows them to compute interest based on the actual number of calendar days after the date of advance, calculated on the basis of a 360-day year. Otherwise, the lender must assume a 365-day year. See *Chern v Bank of America* (1976) 15 C3d 866, 127 CR 110. But see *South Bay Chevrolet v General Motors Acceptance Corp.* (1999) 72 CA4th 861, 85 CR2d 301. Calculating interest based on a 360-day year increases the effective rate of interest and could result in a usurious interest rate if the lender or transaction is not exempt from the usury laws. On usury, see §§3.37-3.44.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.64 F. Form: Time and Mode of Payment--Equal Consecutive Installments of Principal and Interest

§3.64 F. Form: Time and Mode of Payment—Equal Consecutive Installments of Principal and Interest

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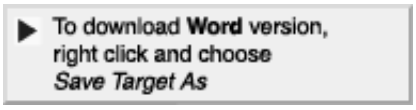

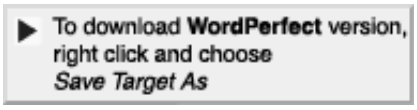

3.64-1 Time and mode of payment—equal consecutive installments of principal and interest

4. Payment of Principal and Interest. Principal and interest shall be payable in consecutive _ _[*e.g., monthly, quarterly, annual*]**_ _ installments of _ _**[*dollar amount*]**_ _ dollars ($_ _**[*dollar amount*]**_ _)**

[*If unlimited prepayment is permitted, add*]

or more

[*Continue*]

on the _ _[*e.g., first*]**_ _ day of each _ _**[*month, quarter, year*]**_ _ beginning _ _**[*month, day, and year first payment is due*]**_ _. Such payments shall continue until the entire indebtedness evidenced by this Note and all accrued and unpaid interest is fully paid, with any unpaid principal and interest due and payable on _ _**[*month, day, and year of final due date*]**_ _ (the Maturity Date).**

Each payment under this Note shall be credited in the following order: (a) costs, fees, charges, and advances paid or incurred by Lender or payable to Lender and interest under any provision of this Note or the Deed of Trust, in such order as Lender, in its sole and absolute discretion, elects, (b) interest payable under the Note, and (c) principal under the Note.

[*If unlimited prepayment is permitted, add*]

All prepayments of principal under this Note shall be applied to the most remote principal installment then unpaid.

Comment: This method of payment provides for substantially equal consecutive payments (typically monthly), which at the inception are almost entirely interest with very little principal amortization repayment. Many calculators and most spread-sheet programs can calculate an amortization schedule that lists each installment and the amount of principal and interest, which total the installment. Also, many books are available that contain amortization schedules for loans of varying interest rate and maturities.

The use of the phrase "or more" following the amount of the monthly payment gives the borrower the right to prepay all, or part, of the principal. This phrase should not be used if prepayment is to be restricted or prohibited. See provision in §3.93 for an alternative method of creating an absolute right of prepayment.

On time and mode of payment, see §§3.8-3.10; on prepayment, see §§3.22-3.34. For additional payment provisions, see §§3.83-3.86; for additional prepayment provisions, see §§3.87-3.92. This provision should be the same as any similar provision in the deed of trust. See 4.109-1.

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§3.65 G. Form: Default

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3.65-1 Default

5. Default. On (a) Borrower's failure to pay any installment or other sum due under this Note when due and payable (whether by extension, acceleration, or otherwise), or (b) an Event of Default (as defined in the Deed of Trust), or (c) any breach of any other promise or obligation in this Note or in any other instrument now or hereafter securing the indebtedness evidenced by this Note, then, and in any such event, Lender may, at its option, declare this Note (including, without limitation, all accrued interest) due and payable immediately regardless of the Maturity Date. Borrower expressly waives notice of the exercise of this option.

Comment: This acceleration clause allows the lender to require payment of the entire unpaid balance of principal and interest if the borrower fails to make a payment as required by the note, or in the event of any other default, either by the note, the deed of trust, or any other agreement or security instrument executed in connection with the loan. On acceleration clauses in deed of trust, see §§4.43-4.45, 4.85. On acceleration on default, see §3.35. Although not required in commercial loans, some attorneys repeat in the note the deed of trust's due-on-encumbrance (or due-on-transfer) provisions.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.66 H. Form: Late Charge; Percentage Amount

§3.66 H. Form: Late Charge; Percentage Amount

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3.66-1 Late charge; percentage amount

6. Late Charge. Borrower acknowledges that default in the payment of any sum due under this Note will result in losses and additional expenses to Lender in servicing the indebtedness evidenced by this Note, handling such delinquent payments, and meeting its other financial obligations. Borrower further acknowledges that the extent of such loss and additional expenses is extremely difficult and impractical to ascertain. Borrower therefore agrees that, if any payment due under this Note is not made within _ _[*number (_)*]_ _ days when due, a charge of _ _[*number*]_ _ cents _ _[*$.__*]_ _ for each dollar ($1.00) that is not paid when due would be a reasonable estimate of expenses so incurred (the Late Charge). If any payment is not received within _ _[*number written out (_)*]_ _ days when due, Borrower shall pay the Late Charge to Lender (without prejudicing or affecting any other rights or remedies of Lender) as liquidated damages to cover expenses incurred in handling such delinquent payment.

Comment: This provision is drafted in an attempt to comply with *Garrett v Coast & S. Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 108 CR 845, in light of the subsequent amendments to CC §§1670-1671. On late payment charges, see §§3.15-3.17. Some financial institutions do not bother to spell out, as the first sentences in this provision attempt to do, the justification for using liquidated damages. Such lenders simply provide that, if the borrower fails to make a payment within a specified number of days after its due date, then the borrower must pay as a late charge a specified percentage of each such past due dollar.

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§3.67 I. Form: Default Interest on Outstanding Principal

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3.67-1 Default interest on outstanding principal

7. Interest on Default. From and after the Maturity Date (either according to the terms of this Note or as the result of an acceleration of the then unpaid principal balance under the terms of this Note), the entire unpaid principal balance shall automatically bear an annual interest rate (instead of the rate specified in _ _[*e.g., paragraph 1*]_ _) equal to the lesser of (a) _ _[*number*]_ _ percent (_ _[*number*]_ _%) or (b) the maximum interest rate allowed by law (the Default Rate).

Comment: An interest rate reflects the return to the lender based on an assessment of risk. That is why extremely creditworthy individuals or companies can borrow funds at a lower interest rate than can a less creditworthy individual or company. A late payment means that the borrower's creditworthiness has probably decreased from the time the loan was made. This decrease in the borrower's creditworthiness means that the borrower should be paying a higher interest rate than originally charged in order to compensate the lender for the increased risk. This provision recognizes the higher risk of a loan made to a borrower who has missed a payment. See §3.36 for further discussion of default interest.

The default rate of interest is called the "default rate." Although this term may not be used again in the note, it is used in the deed of trust. For form, see paragraph 1.3 in §4.66. Using defined terms consistently in all loan documents reduces the chances for ambiguities and misunderstandings.

Even without this provision, interest would continue to accrue (at the note interest rate) on the unpaid principal amount.

WARNING: If a lender or transaction is not otherwise exempt from the California usury law, lender's counsel must be careful that the enforcement of the default rate provision does not convert a legal loan into a usurious one by exceeding the applicable limits on the interest that may be charged. Thus, a savings clause is added to the end of the provision. See §3.76 for a more extensive usury savings clause. On usury, see §§3.37-3.44.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.68 J. Form: Interest on Interest

§3.68 J. Form: Interest on Interest

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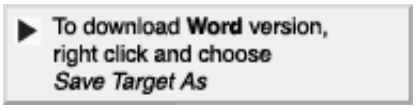

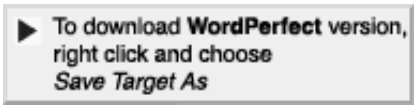

3.68-1 Interest on interest

8. Interest on Interest. If any interest payment under this Note is not paid when due, the unpaid interest shall be added to the principal of this Note, shall become and be treated as principal, and shall thereafter bear like interest.

Comment: This provision allows unpaid interest to bear interest; otherwise, interest accrues only on the principal.

WARNING: To the extent that this provision causes interest to be charged on interest, a lender or transaction not otherwise exempt from the California usury law must be careful that enforcement of this provision does not convert a legal loan into a usurious one by exceeding the applicable limit on the interest that may be charged. Thus, a savings clause should be included in the note. See §3.76.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.69 K. Form: Attorney Fees

§3.69 K. Form: Attorney Fees

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3.69-1 Attorney fees

9. Attorney Fees. Borrower agrees to pay the following costs, expenses, and attorney fees paid or incurred by Lender, or adjudged by a court: (a) reasonable costs of collection and costs, expenses, and attorney fees paid or incurred in connection with the collection or enforcement of this Note, whether or not suit is filed; (b) reasonable costs, expenses, and attorney fees paid or incurred in connection with representing Lender in any bankruptcy, reorganization, receivership, or other proceedings affecting creditors' rights and involving a claim under this Note; (c) reasonable costs, expenses, and attorney fees incurred to protect the lien of the Deed of Trust; and (d) costs of suit and such sum as the court may adjudge as attorney fees in any action to enforce payment of this Note or any part of it.

Comment: A provision on attorney fees may be included in the note without affecting its negotiability. Com C §3104(a)(3). For further discussion of attorney fees, see §3.45.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.70 L. Form: Waiver of Presentment, Notice of Dishonor, and Protest

§3.70 L. Form: Waiver of Presentment, Notice of Dishonor, and Protest

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3.70-1 Waiver of presentment, notice of dishonor, and protest

10. Waiver. Borrower, endorsers, and all other persons liable or to become liable on this Note waive presentment, protest, and demand; notice of protest, demand, and dishonor; and all other notices or matters of a like nature.

Comment: The primary purpose of this provision is to preserve the recovery rights of a subsequent purchaser of the note against the originating lender if the original borrower defaults. For further discussion of waiver of presentment, notice of dishonor, and protest, see §3.46.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.71 M. Form: Manner of Notification

§3.71 M. Form: Manner of Notification

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3.71-1 Manner of notification

11. Notice. Any notice required to be provided in this Note shall be given in writing and shall be sent (a) for personal delivery by a delivery service that provides a record of the date of delivery, the individual to whom delivery was made, and the address where delivery was made; (b) by first-class certified United States mail, postage prepaid, return receipt requested; or (c) by a nationally recognized overnight courier service, marked for next day business delivery. All notices shall be addressed to the party to whom such notice is to be given at the property address stated in this Note or to such other address as a party may designate by written notice to the other. All notices shall be deemed effective on the earliest of (a) actual receipt; (b) rejection of delivery; (c) if sent by certified mail, the third day on which regular United States mail delivery service is provided after the day of mailing or, if sent by overnight delivery service, on the next day on which such service makes next-business-day deliveries after the day of sending.

Comment: To avoid any argument that sufficient notice was not given and to avoid confusion and uncertainty, it is advisable for the protection of both borrower and lender to provide a clear method of delivery of notices. As long as both borrower and lender agree, there is no problem with adding as additional methods of giving notice, *e.g.,* by e-mail or facsimile. If these additional methods are used, it is necessary to set forth each party's e-mail address or facsimile number, and to provide when delivery will be deemed accomplished. It would be time consuming and expensive to require personal delivery of all notices. With large commercial loans, the exact timing of receipt of notice may be very important. The last sentence in this provision is important because of the uncertainty about the time between posting and actual delivery of a written notice, and if a party refuses to accept delivery of a notice. Also, if there are multiple borrowers, the lender may designate one borrower for notice purposes and add a sentence stating that notice to the designated person shall constitute notice to all borrowers. This notice provision eliminates the arguments that might occur if notice were permitted to be given by first-class mail. First-class mail, however, is faster than first-class certified mail, and it is less costly than an overnight delivery service or first-class certified or registered mail.

DRAFTING CONSIDERATIONS: The drafter should review the deed of trust to confirm that the notice provisions are consistent. See, *e.g.*, the provision in §4.107. In a conflict, the provision in the note would normally control. *Pacific Fruit Exch. v Duke* (1930) 103 CA 340, 284 P 729. There may also be statutory notice requirements for certain kinds of notices. For example, CC §2924b(e) requires that notices of default and sale be mailed by both first-class and certified mail.

It is also important to confirm that the lender's address is included in the provision that sets out the address to which payments are to be sent and that the borrower's address is set forth at the end of the note after the signature block.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.72 N. Form: Statement That Note Is Secured by Deed of Trust

§3.72 N. Form: Statement That Note Is Secured by Deed of Trust

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3.72-1 Statement that note is secured by deed of trust

12. Secured by Deed of Trust. This Note is secured by, among other things, that certain Deed of Trust, Assignment of Leases and Rents, Fixture Filing, and Security Agreement (the Deed of Trust) of even date herewith made by Borrower, as trustor, for the benefit of Lender, as beneficiary _ _[*describe any other agreements that secure note, e.g.*, *and that certain Assignment of Lessor's Interest in Leases (the Assignment) of even date herewith executed by Borrower, as assignor, in favor of Lender, as assignee*]**_ _.**

Comment: A note may state that it is secured by a mortgage or deed of trust without losing its status as a negotiable instrument. Com C §§3104(a)(3), 3106(b)(1). Because of the statutory system pertaining to rights and remedies of notes secured by real property (compared with those for notes secured by personal property or unsecured notes), this provision enables the note holder to ascertain on its face that it involves real property security, and act accordingly. As indicated by the bracketed language, to the extent that the note is also secured by other security agreements (*e.g.*, an assignment of leases or personal property security agreement), that fact may also be referred to in the note.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.73 O. Form: Forbearance Not a Waiver

§3.73 O. Form: Forbearance Not a Waiver

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3.73-1 Forbearance not a waiver

13. Forbearance Not a Waiver. If Lender delays in exercising or fails to exercise any of its rights under this Note, that delay or failure shall not constitute a waiver of any Lender rights or of any breach, default, or failure of condition under this Note. No waiver by Lender of any of its rights or of any such breach, default, or failure of condition shall be effective, unless the waiver is expressly stated in a writing signed by Lender.

Comment: See discussion in §§3.18-3.20. See also similar provision in the deed of trust in §4.94. It is helpful to provide that the lender's waiver is effective only if it is in writing and signed. When a loan gets into trouble, it is not unusual for the borrower to claim that the lender orally agreed to change or modify the terms of the note. It is difficult to resolve such claims by summary judgment because it is one person's word against another's. To eliminate disputes about the existence of oral agreements, lenders require this language because it reduces disputes over the existence of a waiver.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.74 P. Form: Assignment

§3.74 P. Form: Assignment

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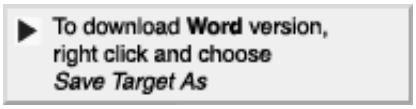

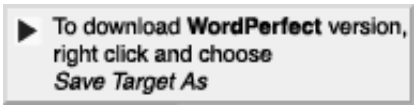

3.74-1 Assignment

14. Assignment. This Note inures to and binds the heirs, legal representatives, successors, and assigns of Borrower and Lender; provided, however, that Borrower may not assign this Note or any proceeds of it, or assign or delegate any of its rights or obligations, without Lender's prior written consent in each instance. Lender in its sole discretion may transfer this Note, and may sell or assign participations or other interests in all or any part of this Note, all without notice to or the consent of Borrower.

Comment: Although this provision is not required by law, if the lender intends to sell the note in a secondary market, including it in the note will facilitate that transaction. Even if the lender does not intend to sell the note at the time the loan is made, including this provision should still be considered because circumstances may change. This provision allows the lender to assign the entire note in jurisdictions where negotiability is an issue and allows the lender to unilaterally make partial assignments of the note. The prohibition on assignment by the borrower is consistent with a due-on-sale or due-on-encumbrance clause. See §3.31 for discussion of the impact of these types of clauses in combination with restrictions on prepayment.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.75 Q. Form: Governing Law

§3.75 Q. Form: Governing Law

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3.75-1 Governing law

15. Governing Law. This Note shall be construed and enforce able according to the laws of the State of _ _[*name*]_ _ for all purposes.

[*If appropriate, add*]

except when federal law applies (including, without limitation, any federal usury ceiling or other federal law preempting state usury laws, which, from time to time, is applicable to the indebtedness evidenced by this Note).

Comment: If an applicable federal law is more advantageous and would ordinarily preempt state law, counsel must be careful not to preclude its application. In this event, the additional clause should be used and the governing law provisions in other loan documents should also be modified. See forms 4.100-1 and 5.27-1 which now call for application of California law.

For further discussion of governing law, see §3.48.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.76 R. Form: Usury

§3.76 R. Form: Usury

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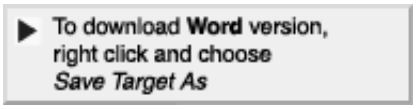

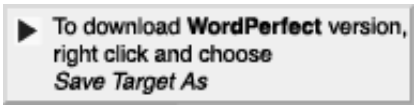

3.76-1 Usury

16. Usury. All agreements between Borrower and Lender are expressly limited, so that in no event or contingency, whether because of the advancement of the proceeds of this Note, acceleration of maturity of the unpaid principal balance, or otherwise, shall the amount paid or agreed to be paid to Lender for the use, forbearance, or retention of the money to be advanced under this Note exceed the highest lawful rate permissible under applicable usury laws. If, under any circumstances, fulfillment of any provision of this Note or the Deed of Trust securing this Note or any other agreement pertaining to this Note, after timely performance of such provision is due, shall involve exceeding the limit of validity prescribed by law that a court of competent jurisdiction deems applicable, then, ipso facto, the obligations to be fulfilled shall be reduced to the limit of such validity. If, under any circumstances, Lender shall ever receive as interest an amount that exceeds the highest lawful rate, the amount that would be excessive interest shall be applied to reduce the unpaid principal balance under this Note and not to pay interest, or, if such excessive interest exceeds the unpaid principal balance under this Note, such excess shall be refunded to Borrower. This provision shall control every other provision of all agreements between Borrower and Lender.

Comment: For further discussion of usury limitations, see §§3.37-3.44.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.77 S. Form: Time of the Essence

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3.77-1 Time is of the essence

17. Time Is of the Essence. Time is of the essence with respect to all obligations of Borrower under this Note.

Comment: For further discussion of time being of the essence, see §3.55. For a more detailed time is of the essence provision, see paragraph 49.6 in 4.114-1.

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§3.78 T. Form: Signature

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3.78-1 Signature

Executed at _ _[*address*]_ _, California, on the _ _[*number, e.g., tenth*]_ _ day of _ _[*date*]_ _.

Borrower

Date: _ _ _ _ _ _ _ _[*Name of limited liability company*]_ _**, a California limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

_ _[*Address of borrower*]_ _

Comment: If the date is *not* on the front of the note, put the date in the signature block as shown in this provision. If the date is on the front of the note, the language preceding the actual signature block above is not needed. If the date is both on the front of the note and in the signature block, the drafter must confirm that the two dates are the same.

The provision in §3.71 on notice refers to the borrower's address as "stated in this Note." The party or parties signing the note should normally be the same party or parties signing the deed of trust and the other loan documents, unless a third party is providing the deed of trust as an accommodation to the borrower. See §4.3 for discussion of possible complications when the trustor and the borrower are not the same.

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§3.79 U. Additional or Alternative Provisions

The provisions in §§3.80-3.103 represent only some types of additional or alternative provisions that might be found in a commercial loan note. Some of them may be included in a lender's standard form note even if they are not relevant to all transactions for which they are used.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.80 1. Form: Joint and Several Liability

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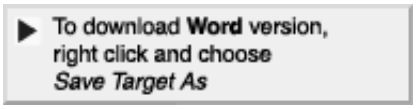

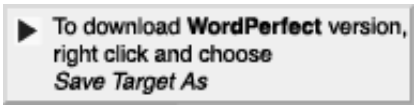

3.80-1 Joint and several liability

__. Joint and Several Liability. If more than one person or entity is signing this Note as Borrower, their liability under this Note shall be joint and several.

Comment: For further discussion of joint and several liability, see §3.47.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.81 2. Form: Interest Rate Based on Reference Rate

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3.81-1 Interest rate based on reference rate

__. Amount of Interest. Interest on the unpaid principal balance shall accrue from the date of advance at an annual rate equal to _ _[*number*]_ _ percentage points above the reference rate charged from time to time by Lender, each change in interest rate to become effective on the effective date of each change in the reference rate announced by Lender. If Lender no longer exists or fails to announce a reference rate, the reference rate shall be that of _ _[*name of other lender or standard of reference, e.g., the largest in terms of total assets of the member banks of the Federal Reserve Bank for the region where the property or the lender is located that then announces a reference rate*]_ _.

Comment: This provision is typical for loans when the interest rate is tied to the reference rate. For further discussion of variable interest rates, see §§1.27, 3.11-3.13.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.82 3. Form: Interest Rate Based on Contingency

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3.82-1 Interest rate based on contingency

__. Amount of Interest. Interest on the unpaid principal balance from time to time outstanding shall accrue from the date of advance at an annual rate of _ _[*original interest rate*]_ _ percent (_ _[*number*]_ _%) per annum until such time as _ _[*specify event that is to occur*]_ _, after which interest shall accrue at an annual rate of _ _[*increased interest rate*]_ _ percent (_ _[*number*]_ _%).

Comment: For further discussion of contingent interest rates, see §3.12.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.83 4. Form: Interest-Only for All or Part of Term

§3.83 4. Form: Interest-Only for All or Part of Term

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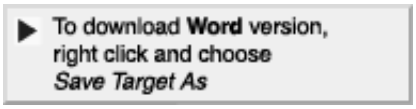

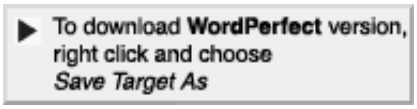

3.83-1 Interest-only for all or part of the term

[*Alternative 1: Interest only for the entire term of the loan*]

__. Payment of Interest and Principal. Interest only shall be payable on the unpaid principal balance of this Note _ _[*e.g., monthly, quarterly, annually*]**_ _ on the _ _**[*e.g., first*]**_ _ day of each _ _**[*e.g., month, quarter, year*]**_ _ commencing on _ _**[*date of first interest-only payment*]**_ _, and continuing for _ _**[*number of*, *e.g., months, quarters, years*]**_ _ until _ _**[*due date*]**_ _, at which time any remaining principal and accrued but unpaid interest shall be due and payable.**

[*Alternative 2: Interest only at the beginning of the term, then loan is amortized*]

__. Payment of Interest and Principal. Interest only shall be payable on the unpaid principal balance of this Note _ _[*e.g., monthly, quarterly, annually*]**_ _ on the _ _**[*e.g., first*]**_ _ day of each _ _**[*e.g., month, quarter, year*]**_ _ commencing on _ _**[*date of first interest-only payment*]**_ _, and continuing for _ _**[*number of, e.g., months, quarters, years*]**_ _. Thereafter, interest and principal shall be payable in consecutive _ _**[*e.g., monthly, quarterly, annual*]**_ _ installments of _ _**[*dollar amount*]**_ _ dollars on the _ _**[*e.g., first*]**_ _ day of each _ _**[*e.g., month, quarter, year*]**_ _ commencing on _ _**[*date of first principal and interest payment*]**_ _, and continuing until _ _**[*due date*]**_ _, at which time any remaining principal and accrued but unpaid interest shall be due and payable.**

Comment: Alternative 1 is an interest-only provision for the life of the loan. Alternative 2 allows a lender to accept lower payments during the early years of a loan, then to shift to an amortization schedule with a higher installment payment for the remaining term of the loan. On balloon payments, see §§3.9, 3.29.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.84 5. Form: Increasing Fixed Installment Payments

§3.84 5. Form: Increasing Fixed Installment Payments

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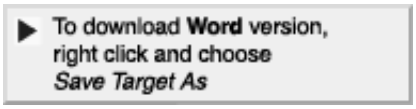

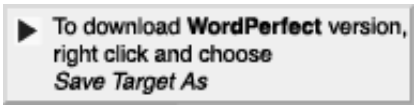

3.84-1 Increasing fixed installment payments

[*Alternative 1: Note bears fixed interest, and new interest rate and effective date are known*]

__. Payment of Interest and Principal. Principal and interest shall be payable on this Note in consecutive _ _[*e.g., monthly, quarterly, annual*]**_ _ installments of _ _**[*dollar amount*]**_ _ dollars on the _ _**[*e.g., first*]**_ _ day of each _ _**[*e.g., month, quarter, year*]**_ _ commencing on _ _**[*date of first payment*]**_ _, and continuing for _ _**[*number*]**_ _ _ _**[*e.g., months, quarters, years*]**_ _, at which time the _ _**[*e.g., monthly, quarterly, annual*]**_ _ installments of principal and interest shall be increased to _ _**[*dollar amount*]**_ _ dollars, continuing until _ _**[*due date*]**_ _, at which time any remaining principal and accrued and unpaid interest shall be due and payable.**

[*Alternative 2: Note has variable interest rate, or new interest rate and effective date are unknown*]

__. Payment of Interest and Principal. Principal and interest shall be payable on this Note in consecutive _ _[*e.g., monthly, quarterly, annual*]**_ _ installments of _ _**[*dollar amount*]**_ _ dollars on the _ _**[*e.g., first*]**_ _ day of each _ _**[*e.g., month, quarter, year*]**_ _ commencing on _ _**[*date of first payment*]**_ _, and continuing for _ _**[*number*]**_ _ _ _**[*e.g., months, quarters, years*]**_ _, at which time the _ _**[*e.g., monthly, quarterly, annual*]**_ _ installments of principal and interest shall be increased to an amount determined by amortizing the outstanding principal balance of this Note, at an interest rate of _ _**[*number*]**_ _ percent, on a monthly basis, over the remaining term of this Note.**

Comment: A promissory note may provide for a change in the amount of the installment payment for many reasons, *e.g.,* to allow a "burn off" of prepaid interest. (If part of a note's interest obligation is prepaid, installment payments may be reduced initially to reflect credit given for prepaid interest against current interest due, or "burning off" prepaid interest. Once current interest obligations have burned off the prepaid interest, installment payments will rise to the level corresponding to the note's face value, interest rate, and amortization period.)

Alternative 1 can be used if the note bears a fixed interest rate and, at the time the note is drafted, both the new interest rate (which is also a fixed rate) and the time it becomes effective are known. This provision can also be used if the note's actual interest rate is unchanged but payments are calculated as if the rate had been changed at a particular time. Alternative 2 can be used if the note bears a variable interest rate or if at the time the note is prepared it is not known when or by how much the interest rate will change, instead of stating in the note what the increased installments will be. This alternative provides that the new installment amount will be an amount that will amortize the note at the new interest rate over the months remaining until the maturity date. On variable interest rates, see §3.12. On timing and mode of payment, see §§3.8-3.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.85 6. Form: Fixed Principal Plus Accrued Interest

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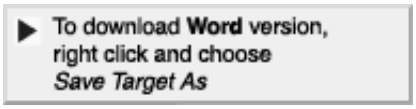

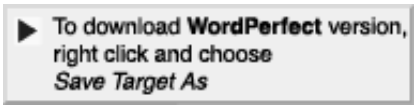

3.85-1 Fixed principal plus accrued interest

__. Payment of Interest and Principal. Principal shall be payable in consecutive equal _ _[*e.g., monthly, quarterly, annual*]**_ _ installments of _ _**[*dollar amount*]**_ _ dollars plus all accrued but unpaid interest as of the date of each principal payment on the _ _**[*e.g., first*]**_ _ day of each _ _**[*e.g., month, quarter, year*]**_ _ commencing on _ _**[*date of first payment*]**_ _, and continuing for _ _**[*number of, e.g., months, quarters, years*]**_ _, at which time the _ _**[*e.g., monthly, quarterly, annual*]**_ _ installments of principal shall be increased to _ _**[*dollar amount*]**_ _ dollars, continuing until _ _**[*due date*]**_ _, at which time any remaining principal and accrued and unpaid interest shall be due and payable.**

Comment: "Interest extra," as this provision is often called, generally means that the periodic principal payments are equal and all accrued interest is included with each payment. This method results in much larger initial payments and lower later payments. Like the provision in §3.84, this provision permits the principal installment amounts to change. If there will be no change, the latter portion of this provision can be deleted.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.86 7. Form: Payment on Demand

§3.86 7. Form: Payment on Demand

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3.86-1 Payment on demand

__. Payment of Interest and Principal. Principal and accrued interest shall be payable _ _[*on demand/within _ _*[*number*]*_ _ days after demand is made*]*_ _* **or if no demand is made, on _ _**[*date*]*_ _.*

Comment: A lender may require that the note be repaid on demand. Some lenders add a due date for repayment if no demand is made. It is prudent for borrower's counsel to request a grace period before the lender can declare a default. On timing and modes of payment, see §§3.8-3.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.87 8. Form: Prepayment Charge Following Acceleration on Default

§3.87 8. Form: Prepayment Charge Following Acceleration on Default

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§3.59-3.104.

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3.87-1 Prepayment charge following acceleration on default

__. Prepayment Charge Following Acceleration on Default. On any default by Borrower and following the acceleration of the maturity of this Note, a tender of payment of the amount necessary to satisfy the entire indebtedness made at any time by Borrower, its successors, or assigns, or by anyone on behalf of Borrower, its successors, or assigns, shall be deemed to be a voluntary prepayment under this Note and any such payment, to the extent permitted by law, will include the additional payment required under the prepayment privilege, if any, set forth in _ _[*paragraph number*]_ _, or, if at that time there is no prepayment privilege and no stated additional payment is required, then such payment will, to the extent permitted by law, include an additional payment of the greater of (a) the additional payment required under the prepayment privilege as though such provisions were in effect, or (b) _ _[*number*]_ _ percent (_ _[*number*]_ _%) of the then-outstanding principal balance of this Note.

Comment: Some lenders express concern that a borrower facing a loan with substantial prepayment penalties might deliberately default, forcing the lender to accelerate, thus avoiding the prepayment penalty. (On acceleration on default, see §3.35.) Some lenders address this situation by adding to the note this type of provision.

Despite this provision's express language, a court might conclude that no prepayment of the note has occurred and refuse to enforce the prepayment penalty provision. See *Tan v California Fed. Sav. & Loan Ass'n* (1983) 140 CA3d 800, 189 CR 775. (*Tan*, however, held that the prepayment clause in question was not broad enough to apply to acceleration under a due-on-sale clause and indicated that a properly drafted clause might entitle the lender to impose a prepayment penalty following acceleration under a due-on-sale clause.)

This provision relates to acceleration resulting from a payment default, but it does not cover acceleration based on a due-on-sale clause. Whether a payment fee can be collected based on a due-on-sale clause depends on the terms of the prepayment provision. If the fee is due "whether said prepayment is voluntary or involuntary, including any prepayment effected by the holder's exercise of the acceleration clause," or similar provision, the fee should be collectible when the lender exercises the due-on-sale clause. *Pacific Trust Co. TTEE v Fidelity Fed. Sav. & Loan Ass'n* (1986) 184 CA3d 817, 229 CR 269. See also *Biancalana v Fleming* (1996) 45 CA4th 698, 53 CR2d 47.

Even if the prepayment language is broad enough to cover acceleration based on a due-on-sale clause, CC §2954.10 imposes additional constraints on collecting such a fee. See §3.31.

For further discussion of prepayment, see §§3.22-3.39. On due-on-sale provision, see §4.43.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.88 9. Form: Lock-In

§3.88 9. Form: Lock-In

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3.88-1 Lock-in

__. Prepayment Prohibited. Borrower may not prepay this Note in whole or in part.

Comment: The use of the phrase "or more" following the amount of the monthly payment or the phrase "on or before" preceding the date of payment in the clause on time and mode of payment (see §3.64) gives the maker an unrestricted right to prepay all or part of the principal. Such a phrase must *not* be used if prepayment is to be restricted or prohibited. On lock-in provisions, see §3.24; on prepayment, see §§3.22-3.34.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.89 10. Form: Phased Lock-In

§3.89 10. Form: Phased Lock-In

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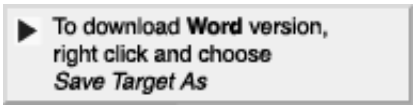

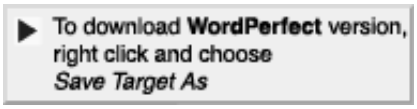

3.89-1 Phased lock-in

__. Prepayment. Borrower may not prepay this Note in whole or in part before _ _[*number*]**_ _ years after the date of this Note.**

Comment: See the Comment in §3.88.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.90 11. Form: Prepayment With Charge

§3.90 11. Form: Prepayment With Charge

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3.90-1 Prepayment with charge

__. Prepayment. Borrower may prepay this Note in whole or in part after _ _[*number (lock-in period)*]_ _ years from the date of this Note, on payment of a prepayment premium of _ _[*number*]_ _ percent (_ _[*number*]_ _%) of the amount of the principal prepaid. The amount of the prepayment premium shall decrease by _ _[*number*]_ _ percentage points for each year after _ _[*number (lock-in period)*]_ _ in which prepayment is not made, but never below _ _[*number*]_ _ percent (_ _[*number*]_ _%). Each prepayment shall be accompanied by the amount of all accrued and unpaid interest on the amount prepaid. All prepayments of principal on this Note shall be applied to the most remote principal installment or installments then unpaid.

Comment: See Comment in §3.88.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.91 12. Form: Prepayment Privilege Without Charge

§3.91 12. Form: Prepayment Privilege Without Charge

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3.91-1 Prepayment privilege without charge

__. Right To Prepay. Borrower may prepay the principal amount outstanding in whole or in part at any time without charge. Partial prepayments shall be accompanied by interest on the amount prepaid through the date of prepayment. All prepayments of principal on this Note shall be applied to the most remote principal installment or installments then unpaid.

Comment: Unrestricted prepayment can also be provided for by adding the words "or more" after the amount of the monthly payment or the words "on or before" preceding the date of payment set forth in the clause in §3.64. On prepayment, see §§3.22-3.34.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.92 13. Form: Limited Prepayment Privilege Without Charge

§3.92 13. Form: Limited Prepayment Privilege Without Charge

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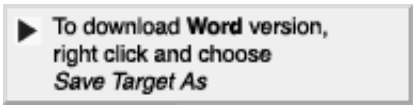

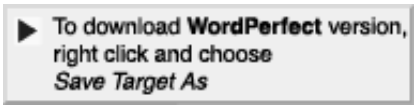

3.92-1 Limited prepayment privilege without charge

__. Prepayment. Borrower may prepay the principal amount outstanding in whole or in part without penalty. Lender may require that any partial prepayments (a) be made on the date _ _[*e.g., monthly, quarterly, annual*]**_ _ installments are due and (b) be in the amount of that part of one or more _ _**[*e.g., monthly, quarterly, annual*]**_ _ installments of**

[*Add one of the following alternatives*]

[*Alternative 1: If the note has a single payment of principal and interest combined (see Alternative 2 in §3.83)*]

principal and interest.

[*Alternative 2: If the note has a fixed principal payment plus accrued interest (see §3.85)*]

principal.

[*Continue*]

All prepayments of principal on this Note shall be applied to the most remote principal installment or installments then unpaid.

Comment: See Comment in §3.88.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.93 14. Form: Limited Prepayment

§3.93 14. Form: Limited Prepayment

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3.93-1 Limited prepayment

__. Prepayment. Borrower may prepay principal in whole or in part before the Maturity Date in minimum amounts equal to or greater than 20 percent of the face amount of this Note. All prepayments of principal on this Note shall be applied to the most remote principal installment or installments then unpaid. Borrower shall give Lender irrevocable written notice of Borrower's intention to make the prepayment, which notice shall specify the date and amount of the prepayment. The notice must be received by Lender at least _ _[*number*]_ _ days before the prepayment. Each prepayment, whether voluntary, by reason of acceleration, or otherwise, shall be accompanied by the amount of all accrued interest on the amount prepaid.

Comment: It is usually a good idea to establish a minimum sum that may be prepaid. As an alternative to a percentage minimum, some lenders require that partial prepayments be in integral multiples of a stated dollar amount. Notice of prepayment should also be irrevocable to permit the lender to plan other uses for the money immediately on receipt. Finally, when drafting a provision that permits prepayment, it is important to include language requiring interest on the sum prepaid to accompany the prepayment. On prepayment, see §§3.22-3.34.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.94 15. Form: Prepayment Application

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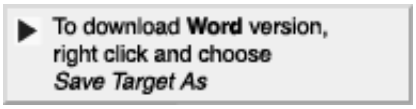

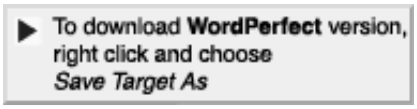

3.94-1 Prepayment application

__. Prepayment Application. Any prepayment of principal shall be applied to the _ _[*next/last*]_ _ payment or payments due under this Note.

Comment: If a principal prepayment is applied to the next payment or payments due, then the prepayment will be reflected in lower installment payments in the immediate future. If applied to the last payments, the prepayment would have no effect on current installment obligations, except that, under an amortized payment schedule, the interest portion of future payments would be reduced.

On prepayment application, see §3.34.

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§3.95 16. Form: Optional Due Date

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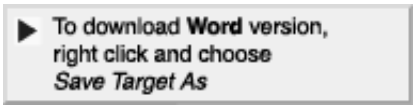

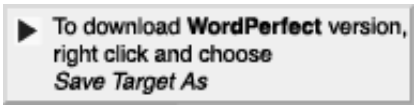

3.95-1 Optional due date

__. Optional Due Date. Principal and interest shall be payable in consecutive _ _[*e.g., monthly, quarterly, annual*]**_ _ installments of _ _**[*dollar amount*]**_ _ dollars ($_ _**[*dollar amount*]**_ _) on the _ _**[*e.g., first*]**_ _ day of each _ _**[*e.g., month, quarter, year*]**_ _ beginning on _ _**[*e.g., month, day, and year first payment due*]**_ _, until the entire indebtedness evidenced by this Note and all accrued but unpaid interest is fully paid, with any unpaid principal and all accrued but unpaid interest due and payable on _ _**[*due date*]**_ _; provided, however, that despite anything provided above to the contrary, this Note shall be due and payable on _ _**[*optional due date*]**_ _, if Lender gives written notice to Borrower of such revised payment date on or before _ _**[*notice date*]**_ _.**

Comment: In periods of inflation and interest rate fluctuations, many permanent lenders reconsider the economic advisability of long-term fixed interest rate loans. Borrowers, however, often cannot afford to pay off a loan on a shorter than normal amortization schedule. One approach permanent lenders use as an alternative to a variable interest rate or an absolute balloon payment is a balloon payment provision that is operative only at the option of the permanent lender. Obviously, if interest rates increase substantially over the fixed rate or if other customary lending practices change, the permanent lender will exercise its option and call the loan; but if interest rates decline, the lender will not accelerate. Counsel for the borrower should require as much advance notice as possible of lender's intent to call the note in order to give the borrower sufficient time to refinance.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.96 17. Form: Subordination

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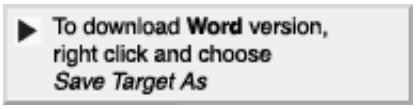

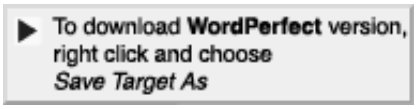

3.96-1 Subordination

__. Subordination. This Note and the lien of the Deed of Trust securing this Note are subject to subordination to a note and the deed of trust securing it as provided in the Deed of Trust securing this Note.

Comment: On the rules for and factors governing subordination, see §3.21.

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§3.97 18. Form: Disclaimer of Personal Liability

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§3.59-3.104.

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3.97-1 Disclaimer of personal liability

__. Nonrecourse. Despite anything to the contrary in this Note or in the Deed of Trust securing this Note, but without in any way affecting the validity of this Note or of the lien of the Deed of Trust, in the event of any default under this Note or the Deed of Trust, Lender's sole recourse for any and all such defaults shall be by judicial foreclosure or by exercise of the trustee's power of sale, and the undersigned _ _[*and the members of the undersigned*]_ _ shall not be personally liable for the payment of this Note or for any other default under the Deed of Trust or for the payment of any deficiency established after judicial foreclosure or after a trustee's sale under the Deed of Trust.

Despite the foregoing, Borrower shall be personally liable for:

__.1 All losses, damages, costs, and expenses (including attorney fees) incurred by Lender as a result of (a) any failure after the occurrence and during the continuance of any Event of Default (as defined in the Deed of Trust) (without benefit of any applicable grace or cure period), to apply any portion of the gross income from the Mortgaged Property (as defined in the Deed of Trust) to this Note or to customary operating expenses of the Mortgaged Property; (b) fraud; (c) any misappropriation of funds; (d) any material misrepresentation by Borrower; or (e) any material waste or abandonment of the Mortgaged Property; and

__.2 Repayment of the Loan (as defined in the Deed of Trust) and all other obligations of Borrower under the Loan Documents (as defined in the Deed of Trust) in the event of (a) any breach of any of the covenants in _ _[*paragraph number*]_ _ of the Deed of Trust pertaining to transfers of interests and additional encumbrances, or (b) the filing by Borrower, or the filing against Borrower by any principal, of any proceeding for relief under any federal or state bankruptcy, insolvency, or receivership laws or any assignment for the benefit of creditors made by Borrower.

Comment: This disclaimer of personal liability provides "downside" protection to a wealthy and highly liquid borrower. For further discussion of the disclaimer of personal liability, see §§3.49-3.51.

The "carveouts" or exceptions create personal liability in certain circumstances. The provisions of subsection __.1 are fairly standard and difficult for a borrower to successfully resist. The provisions of subsection __.1(a) apply only if the property securing the note is income property. The provisions of subsection __.2 are usually found in conduit loans and are successfully resisted by borrowers in nonconduit loan transactions.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.98 19. Form: Cross-Default

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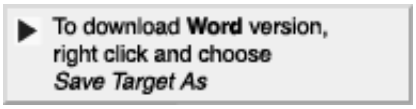

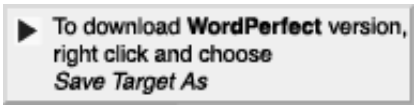

3.98-1 Cross-default

__. Cross-Default. Any default by Borrower as to any other loan or loans by Lender to Borrower shall at Lender's option constitute a default under this Note.

Comment: For further discussion of cross-default, see §3.52.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/3 The Promissory Note/§3.99 20. Form: Waiver of Statute of Limitations

§3.99 20. Form: Waiver of Statute of Limitations

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3.99-1 Waiver of statute of limitations

__. Waiver of Statute of Limitations. The pleading of any statute of limitations as a defense to the obligations evidenced by this Note is waived to the fullest extent permissible by law.

Comment: For further discussion of waiver of statute of limitations, see §3.53.

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§3.100 21. Form: Severability

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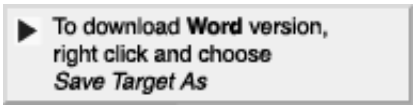

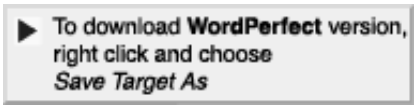

3.100-1 Severability

__. Severability. If any provision of this Note, or the application of it to any party or circumstance, is held void, invalid, or unenforceable by a court of competent jurisdiction, the remainder of this Note, and the application of such provision to other parties or circumstances, shall not be affected thereby, the provisions of this Note being severable in any such instance.

Comment: For further discussion of severability, see §3.54. For a form that requires provisions to be construed in the lender's favor, see form 6.99-1.

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§3.101 22. Form: Waiver of Statutory Regulation

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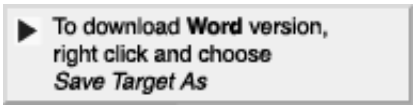

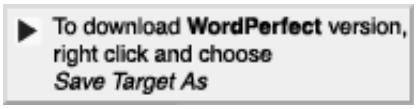

3.101-1 Waiver of statutory regulation

__. Waiver of Statutory Regulation. By initialing below, Borrower waives any right under California Civil Code §2954.10 or otherwise to prepay this Note, in whole or in part, without a prepayment premium (as described in _ _[*e.g., paragraph _ _ (form 3.90-1)*]_ _). Borrower acknowledges that prepayment of this Note may result in Lender's incurring additional losses, costs, expenses, and liabilities, including, but not limited to, lost revenue and lost profits. Borrower therefore agrees to pay the prepayment premium if any principal amount is prepaid, whether voluntarily or by reason of acceleration of the Maturity Date on default (including, but not limited to, acceleration on any transfer or conveyance of any right, title, or interest in the Mortgaged Property giving Lender the right to accelerate the maturity of this Note as provided in the Deed of Trust).

BORROWER AGREES THAT LENDER'S WILLINGNESS TO OFFER TO BORROWER THE INTEREST RATE DESCRIBED ABOVE IS SUFFICIENT AND INDEPENDENT CONSIDERATION, GIVEN INDIVIDUAL WEIGHT BY LENDER, FOR THIS WAIVER. BORROWER UNDERSTANDS THAT LENDER WOULD NOT OFFER SUCH AN INTEREST RATE TO BORROWER ABSENT THIS WAIVER.

_____
Borrower's Initials

Comment: Many lenders include an identical provision in the deed of trust although it is not required by law. Furthermore, to address the "course of conduct" requirement in CC §2954.10, it is prudent (but not obligatory) for a lender to include appropriate language on this issue in the loan commitment agreement, if any.

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§3.102 23. Form: Representation on Use of Proceeds

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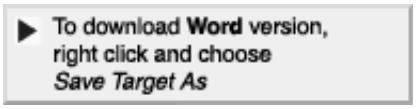

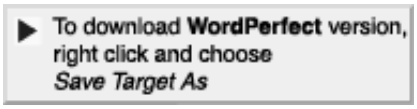

3.102-1 Representation on use of proceeds

__. Representation on Use of Proceeds. Borrower represents and warrants to Lender that the proceeds of this Note will be used solely for business, commercial investment, or similar purposes, and that no portion of it will be used for personal, family, or household purposes.

Comment: It is important to include this representation if the lender is making a loan secured by commercial real estate when the use of the proceeds is not otherwise controlled by the lender (*e.g.,* through an escrow requiring the proceeds to be advanced to the seller of the real property security). It provides the lender with a basis for charging an interest rate that might otherwise be usurious (on a commercial loan, the lender has the benefit of the possibly higher alternative limit of 5 percentage points over the Federal Reserve Board rate).

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§3.103 24. Form: Waiver of Jury Trial

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§3.59-3.104.

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3.103-1 Waiver of jury trial

__. WAIVER OF JURY TRIAL. LENDER AND BORROWER EACH HEREBY VOLUNTARILY, KNOWINGLY, IRREVOCABLY, AND UNCONDITIONALLY WAIVE THEIR RESPECTIVE RIGHTS TO A TRIAL BY JURY OF ANY CLAIM OR CAUSE OF ACTION BASED ON, ARISING FROM, OR RELATED TO THIS NOTE OR THE TRANSACTIONS CONTEMPLATED BY THIS NOTE, IN ANY ACTION, PROCEEDING, OR OTHER LITIGATION OF ANY TYPE BROUGHT BY EITHER PARTY AGAINST THE OTHER, WHETHER WITH RESPECT TO CONTRACT CLAIMS, TORT CLAIMS, OR OTHERWISE. BORROWER AND LENDER AGREE THAT ANY SUCH CLAIM OR CAUSE OF ACTION SHALL BE TRIED BY A COURT TRIAL WITHOUT A JURY. WITHOUT LIMITING THE FOREGOING, THE PARTIES FURTHER AGREE THAT THEIR RESPECTIVE RIGHT TO A TRIAL BY JURY IS WAIVED BY OPERATION OF THIS SECTION AS TO ANY ACTION, COUNTERCLAIM, OR OTHER PROCEEDING THAT SEEKS, IN WHOLE OR IN PART, TO CHALLENGE THE VALIDITY OR ENFORCEABILITY OF THIS NOTE. THIS WAIVER SHALL APPLY TO ANY FUTURE AMENDMENTS, RENEWALS, SUPPLEMENTS, OR MODIFICATIONS TO THIS NOTE.

Comment: Lenders have traditionally been averse to juries deciding claims against them. This aversion accounted, many years ago, for the inclusion in many notes and loan agreements of arbitration provisions. Arbitration provisions were used instead of jury trial waivers because there was concern that such waivers would not be enforce able. In 2005, the California Supreme Court ruled in *Grafton Partners LP v Superior Court* (2005) 36 C4th 944, 32 CR3d 5, that under the California Constitution, contractual predispute jury waivers are unenforceable. The constitution states that in a civil action, the litigants may waive their right to a jury trial as prescribed by statute, and CCP §631 prescribes only six means for waiving a jury trial. Because a contractual agreement made before any dispute arising between the contracting parties is not one of the means authorized by §631, the court concluded that a predispute agreement to waive the right to a jury trial is unenforceable. For further discussion, see §§4.58, 4.115, and 6.88.

PRACTICE TIP: Because the California legislature may enact an amendment superseding the decision in *Grafton,* it may be prudent for lenders to continue to include a jury waiver clause. The clause, however, should also include a severability provision to address the effect of the jury waiver being found unenforceable in an action. See form in §3.100 for a severability provision. The waiver may also be accompanied by an arbitration or judicial reference clause that is set up to apply alternatively if the legislature has not acted to permit jury waivers. See sample clauses in §4.115. See also Retail Leasing: Drafting and Negotiating the Lease, chap 36 (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease, chap 33 (Cal CEB 1996).

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§3.104 25. Form: Financial Covenant

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§3.59-3.104.

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

3.104-1 Financial covenant

__. Financial Covenant. Borrower shall at all times maintain a minimum debt service coverage (net operating income, adjusted for nonrecurring and noncash items, divided by annual debt service) of _ _[*quotient; e.g., 1.25*]**_ _, measured on an annual basis per tax returns.**

Comment: When the income from the real property security is the primary or sole source of the monthly loan payments, the lender often includes a covenant by the borrower that a certain debt service coverage will be met for the loan at all times. Debt service coverage is the relationship between the annual net income from the property and the annual debt service (loan payments). Debt service coverage can be expressed as a ratio such as 1.25:1, meaning that the net income is 1.25 times the debt service. The same ratio may be expressed as a percentage, *e.g.*, 125 percent, or as the quotient obtained by dividing the net income by the debt service (1.25 in this case). This paragraph expresses the debt service coverage as a quotient, not a percentage or ratio. The debt service coverage is usually an item for negotiation between lender and borrower. For a definition of debt service coverage, see §1.36.

NOTE: This type of covenant is often found in a loan agreement. In transactions when a loan agreement is not used, this type of covenant may be placed in the promissory note or in the deed of trust.

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4

The Deed of Trust

C. Darrell Sooy
Morgan T. Jones, III

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I. SCOPE OF CHAPTER

§4.1 A. Deed of Trust Versus Mortgage

The document most often used for security purposes in real property lending in California is the deed of trust. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 1 (4th ed Cal CEB 2009). Other than the nomenclature of the parties and the absence of a trustee under a mortgage, in California, a mortgage with power of sale is virtually identical to a deed of trust. *Aviel v Ng* (2008) 161 CA4th 809, 74 CR3d 200. The only real distinctions lie in the method of clearing title free of the lien when the obligation is satisfied and in the voidability of the instrument when there is a forgery. See *Domarad v Fisher & Burke, Inc.* (1969) 270 CA2d 543, 553, 76 CR 529.

In a forgery case, this distinction results in a significant difference between the use of a deed of trust as opposed to a mortgage. In *Schiavon v Arnaudo Bros.* (2000) 84 CA4th 374, 100 CR2d 801, a trustor, under a deed of trust, forged the beneficiary's signature on a letter of instruction to the trustee, requesting a reconveyance of the deed. Once the deed was reconveyed, the trustor sold the property to a bona fide purchaser. The court found that the forged letter of instruction made the reconveyance *voidable* (not absolutely void) so that a bona fide purchaser would not be subject to the lien. If a mortgage had been used instead of a deed of trust, however, there would have been no trustee and the mortgagee itself would be signing the recorded release of the mortgage. If the mortgagor had forged the release of mortgage, it would have been *absolutely void* because a forged conveying instrument, including a release of mortgage or reconveyance of deed of trust, is absolutely void. *Wutzke v Bill Reid Painting Serv.* (1984) 151 CA3d 36, 198 CR 418.

NOTE: In practice, the real estate industry usually refers to deeds of trust as if they were mortgages. For example, institutional lenders sell pools of "mortgages" and "Mortgage Backed Bonds," and their variable rate lending instruments are referred to as adjustable rate mortgages (ARMs), even though the security instruments are all deeds of trust.

This chapter discusses and presents deed of trust provisions used by institutional lenders in commercial real property lending. The reader should understand that these provisions and the comments on them apply equally to mortgages.

There are advantages to having a loan secured by real property. In California, however, doing so involves some significant limitations on a lender's remedies because the lender becomes subject to the one-action rule and the antideficiency statutes in connection with the transaction. For a discussion of the one-action rule and the antideficiency statutes, see Mortgage Deed of Trust Foreclosure, chaps 4-5. These limitations cannot be waived at the inception of a transaction. CC §2953; *Freedland v Greco* (1955) 45 C2d 462, 467, 289 P2d 463; *California Bank v Stimson* (1949) 89 CA2d 552, 555, 201 P2d 39; *Winkelman v Sides* (1939) 31 CA2d 387, 409, 88 P2d 147. For cases illustrating the adverse impact of trust deed-secured status on creditors who did not anticipate the disadvantages of securing the debt with real property, see *DiSalvo v DiSalvo (In re DiSalvo)* (Bankr 9th Cir 1998) 221 BR 769, rev'd in part on other grounds at *DiSalvo v DiSalvo (In re DiSalvo)* 219 F3d 1035, and *Oropallo v Oropallo* (1998) 68 CA4th 997, 80 CR2d 669. For an example of fractionalizing the debt to avoid subjecting all of it to the disadvantages of real estate-secured status, see *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873.

PRACTICE TIP: Prospective lenders should not become so immersed in the issue of how to take a security interest in land that they fail to ask the more basic question of whether doing so is prudent. Real estate security in California should probably be avoided if it is merely a hedge or a minor part of the collateral package. Alternatively, the debt may be fractionalized into parts, some of which are (and some of which are not) secured by real estate. To avoid the strictures of CCP §580b, a lender may consider taking a deed of trust on property owned by the borrower other than the property being acquired with the proceeds of the purchase money loan. See Mastromonaco, *DeBerard Properties, Ltd. v Lim*: *Are Borrowers Helped or Hurt?* 22 CEB Real Prop L Rep 166 (Aug 1999). But see *Conley v Matthes* (1997) 56 CA4th 1453, 66 CR2d 518, and *BMP Prop. Dev. v Melvin* (1988) 198 CA3d 526, 243 CR 715. For discussion of the basics of secured transactions, see Hansen, *Wielding the Two-Edged Sword:*

What Every Attorney Needs To Know About Real Property Secured Transactions, 22 CEB Real Prop L Rep 122 (July 1999) [Part I: Creating the Security], 22 CEB Real Prop L Rep 159 (Aug. 1999) [Part II: Enforcing Trust Deeds].

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§4.2 B. Institutional Lender's Forms; Uniformity; Capital Markets Mortgage (CMM)

Institutional lenders, particularly banks and savings and loan associations, often use standard form loan documents, including standard deeds of trust. A standard commercial deed of trust is presented in §§4.62-4.117 and discussed in §§4.14-4.58. The provisions of these standardized forms are generally similar among institutions. In fact, for residential loans, most institutions now use the uniform deed of trust prepared by two quasi-government entities, the Federal National Mortgage Association (FNMA or "Fannie Mae") and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac"), for use in the secondary loan market (sale of existing loans). The use of these uniform national instruments is required if loans are to be sold to either FNMA or FHLMC. Many other purchasers of loans in the secondary market insist on these uniform documents primarily so that they do not have to review an individual lender's form each time they make a new purchase.

The basic FNMA/FHLMC Uniform Instrument is for use with first lien single-family home loans. Single-family is defined as a one-to-four-unit family residence. Other uniform instruments exist for multifamily and junior lien loans. For online versions of these instruments, see the websites for FNMA and FHLMC in the Directory.

For nonresidential or commercial loans, the Capital Consortium, a confederation of industry trade associations, developed a standard form known as the Capital Markets Mortgage (CMM). The CMM is "rated" by agencies such as Moody's and Standard & Poor's for use in commercial mortgage-backed securities (CMBS; see §§1.18, 1.33, 1.90-1.107, chap 10) and is the most commonly used form in conduit and other securitized loans. For an extensive discussion of the CMM by its principal drafter, see Forte, *A Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street,* 31 Real Prop, Prob, & Tr J (1996). Although the CMM has been primarily used for structured financing of pools of collateralized commercial mortgages, it is instructive for other loan types because it highlights the types of representations, warranties, and other provisions of interest to the rating agencies. For further discussion of securitized commercial mortgage loans, see chap 10.

In this chapter, the term "commercial real property" lending or loans means loans secured by other than single-family, one-to-four-unit residential property, *e.g.,* apartment houses (five or more units), medical clinics or offices, other office buildings, freestanding retail buildings, shopping centers, industrial-manufacturing and warehouse buildings, motels and hotels, restaurants, nursing homes, mobilehome parks, recreational property, and other non-single-family uses.

NOTE: Commercial loans have become almost as salable in the secondary market as residential loans, even though the types of real property security can be very diverse and the number of individual loans in a pool may be smaller.

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II. PARTIES TO THE DEED OF TRUST

§4.3 A. Trustor

The trustor in a deed of trust is the owner of an estate in real property on which a lien is given as security for the performance of an obligation. In most institutional loans, the trustor is the debtor of a monetary obligation, and the terms "trustor," "debtor," and "borrower" are used interchangeably. Although the trustor is usually the person required to perform the obligation, the obligation may be that of someone other than the trustor. If the trustor is not the obligor under the secured obligation, the trustor is a guarantor for the obligor (see CC §2787), and the lender should include suretyship waivers in the deed of trust or in a separate agreement. For form of suretyship waivers, see §4.122. See *Mead v Sanwa Bank Cal.* (1998) 61 CA4th 561, 71 CR2d 625. The trustor of a deed of trust corresponds to the mortgagor in a mortgage.

A fee simple absolute estate is the one most commonly owned and given as security by the trustor. The leasehold interest of a ground lessee is the second most prevalent estate subjected to the lien of deeds of trust in commercial transactions. Estates of unknown duration (*e.g.*, life estates, the interest of one joint tenant) are rarely acceptable as security for institutional lenders unless all the holders of the concurrent and future interests (*e.g.*, other joint tenants and remaindermen) also execute the deed of trust, thus giving the lender the equivalent of a lien on the fee title. In a leasehold mortgage loan, an institutional lender may require a subordinated fee leasehold mortgage (*i.e.,* a deed of trust under which the lessor also encumbers its reversionary interest in the fee and the lessee encumbers its leasehold interest), especially if the lessor and the lessee are related entities or the loan is a construction loan. This also effectively gives the lender the equivalent of a lien on fee title.

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§4.4 B. Beneficiary

The beneficiary of a deed of trust is the party to whom the obligor, normally the trustor/borrower, owes performance of the secured obligation. In most first lien situations, the beneficiary is the institutional lender who financed the purchase or development of the real property or refinanced an existing loan. The beneficiary of a deed of trust corresponds to the mortgagee in a mortgage.

Although the named beneficiary is the original holder of the underlying obligation (the payee of the promissory note in a typical transaction), the lender/beneficiary occasionally sells the loan or a participation interest in it to other parties. If the whole loan is sold, the beneficiary will record an assignment of its beneficial interest to the new lender/beneficiary. If only an undivided or participation interest in the loan is sold, normally no assignment indicating the transfer of an interest in the loan will be recorded and the originating lender (often called the "lead lender") usually continues to service the loan for the benefit of the other purchasers (usually known as "participants"), who typically are not in privity of contract with the borrower, subject to the terms of a loan participation agreement. The loan participation agreement governs such matters as the servicing of the loan before default and collection of the loan after default. The lead lender generally has authority to make most of the decisions regarding the loan, subject only to the consent of a majority of the participants on major decisions such as advancing more money or changing the interest rate or maturity date. For further discussion of loan participations, see §1.42.

Occasionally, the deed of trust may name multiple beneficiaries. Civil Code §2941.9 provides a decision making procedure for multiple named beneficiaries of a deed of trust. If a deed of trust secures a series of notes in favor of multiple beneficiaries or secures a single note in which multiple beneficiaries have undivided interests "equivalent to a series transaction," all the beneficiaries may agree to be governed by beneficiaries holding more than 50 percent of the "record beneficial interest" in the notes. The statute does not define "equivalent to a series transaction" or "record beneficial interest." The potential matters for decision by the beneficiary majority include preforeclosure issues relating to the loan (*e.g.,* default, foreclosure) and postforeclosure issues relating to the property (*e.g.,* broker selection, sales, leases). CC §2941.9(b). The authorization for future majority decisions must be by prior written agreement of all beneficiaries and must be included in a recorded document such as a deed of trust or an assignment of deed of trust. See CC §2941.9(c).

See Lott, Makel & Evans, *Multiple Lender Transactions: Current Issues* (Part 2), 112 Banking LJ 846 (Oct. 1995).

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§4.5 C. Trustee

The trustee of a deed of trust is the party to whom the trustor conveys title for security purposes. The trustee is not a true trustee, but acts as a common agent of the trustor and beneficiary and owes no fiduciary obligations. The sole duties of the trustee are: (1) on a default on the secured obligation and instruction from the beneficiary, to foreclose, and (2) on satisfaction of the secured obligation, to reconvey the deed of trust. *State ex rel Bowen v Bank of America Corp.* (2005) 126 CA4th 225, 231, 23 CR3d 746; *Hatch v Collins* (1990) 225 CA3d 1104, 275 CR 476; *Lupertino v Carbahal* (1973) 35 CA3d 742, 111 CR 112. The trustee's duties are regulated by both contract and statutory law. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 2 (4th ed Cal CEB 2009). Institutional lenders based in California often use a wholly owned subsidiary corporation as the trustee in the deeds of trust securing the institution's loans. Out-of-state lenders commonly use title companies as trustees.

NOTE: Some institutional lenders name themselves as both beneficiary and trustee in their deeds of trust to avoid having to create a subsidiary corporation, which may have a higher tax rate than the parent financial institution.

Deeds of trust commonly provide for the right to substitute trustees by recording a Substitution of Trustee. See §4.49. Even if the deed of trust does not cover substitution of trustees, CC §2934a contains a statutory procedure that beneficiaries can follow. With multiple beneficiaries, the statute allows a majority of the beneficiaries to execute a substitution of trustee. This procedure may be used if the deed of trust secures multiple notes in favor of multiple beneficiaries or if it secures a single note in which the beneficiaries have undivided interests "equivalent to a series transaction." CC §2934a(a)(1)(B).

There is no party in a mortgage equivalent to a trustee in a deed of trust.

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III. LEGAL REQUIREMENTS FOR VALIDITY

§4.6 A. Description of Debt

The legal requirements for a deed of trust are generally the same as those for deeds in general. To be valid, a deed of trust must

- be in writing (CC §§1091, 2922);
- be signed by the party transferring the interest (CC §1091);
- be delivered to the beneficiary (*Le Mesnager v Hamilton* (1894) 101 C 532, 35 P 1054); and
- contain sufficient descriptions of the parties and the real property (*Dool v First Nat'l Bank* (1929) 207 C 347, 278 P 233).

See generally California Real Property Sales Transactions, chap 10 (4th ed Cal CEB 2007).

Although a deed of trust without a description of the secured obligation is still valid (*Lovelady v Bryson Escrow, Inc.* (1994) 27 CA4th 25, 30, 32 CR2d 371), counsel should include a description of the secured obligation, usually a promissory note. The purpose of describing the debt is to give subsequent lienholders notice (constructive notice by recordation) of the debt so that, with reason able diligence, they can ascertain the nature and extent of the encumbrance that will have priority over theirs.

Reported decisions have not required any specific detailing of the terms of the secured obligation. With a fixed-rate, fixed-term promissory note, the deeds of trust used by institutional lenders usually refer to the parties (*e.g.,* lender/beneficiary and debtor/trustor) and the amount and date of the promissory note. The maturity date, interest rate, and amount of monthly payments are usually not disclosed, except that the final maturity date is disclosed on the FNMA/FHLMC Uniform Instrument. If the final maturity date in the deed of trust is ascertainable from the recorded evidence of indebtedness, the lien of the deed of trust expires 10 years after the maturity date. If the final maturity date is not ascertainable from the recorded evidence of indebtedness, the lien of the deed of trust expires 60 years after the recordation of the deed of trust. CC §882.020(a); *Miller v Provost* (1994) 26 CA4th 1703, 33 CR2d 288. See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 3 (4th ed Cal CEB 2009). If the lien of a deed of trust expires, it is unenforceable by any means. CC §882.030. If notice of intent to preserve the security interest is recorded during the 10- or 60-year period, respectively, the effectiveness of the lien is extended for a period of 10 years after the recordation of the notice. CC §882.020(a)(3). In addition, a new 10-year period should commence on the filing of a lis pendens in an action for judicial foreclosure of the deed of trust during the initial 10-year period. *Slintak v Buckeye Retirement Co.* (2006) 139 CA4th 575, 43 CR3d 131. It is unclear whether such filing of a lis pendens would have any effect on the 60-year period. The statute of limitations on the secured obligation applies to bringing a judicial foreclosure action, but the time period may be extended as provided in CCP §360.5. See §4.41.

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§4.7 B. Recordation

Recordation is not a legal requirement for deeds of trust. If the lender wishes to obtain priority over subsequent bona fide purchasers and encumbrancers for value, however, the lender must record the deed of trust in the county in which the real property is situated to give constructive notice of its contents to the world. On recordation generally, see California Real Property Sales Transactions, chap 15 (4th ed Cal CEB 2007).

To be recorded, a deed of trust must

- comply with the format requirements necessary for recordation (Govt C §27361.6);
- be legible enough to be copied (uncodified, but recorders and title companies will bounce back illegible documents);
- be in English, unless a translation certified by the county clerk is attached (Govt C §27293);
- contain sufficient descriptions of the real property and parties (Govt C §27288.1);
- contain a certification of acknowledgment or other acceptable proof (Govt C §27288); and
- contain the trustor's address and the trustor's request for a copy of any notice of default or notice of sale (Govt C §27321.5).

The acknowledgment must be of the trustor's signature. With more than one trustor, each signature must be acknowledged. Civil Code §1189 establishes one general form for the acknowledgment of an instrument. Under CC §1189(a), the general use acknowledgment must be substantially in the format shown in §4.117.

The Electronic Recording Delivery Act of 2004 (Govt C §§27390-27399), adopted effective September 1, 2004, provides a preview of the future for recording real property instruments. The Act authorizes county recorders, on approval by their board of supervisors and system certification by the attorney general, to establish an electronic recording delivery system for the recording of specified digitized and digital electronic records. The electronic recording delivery systems must include a secure method for recording a digital or digitized electronic record that is an instrument affecting a right, title, or interest in real property or an instrument of reconveyance, substitution of trustee, or assignment of deed of trust. The attorney general must adopt regulations for system requirements and is to monitor systems statewide. The Act establishes requirements for the electronic signature of notaries and for auditing. Participating counties may impose fees to cover the direct cost of regulating the system. The Act also establishes civil remedies for violations of the Act and authorizes the attorney general, a district attorney, or a city prosecutor to seek such remedies.

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§4.8 IV. COMMONLY NEGOTIATED TERMS

Specific negotiated terms will be discussed under the separate headings for the paragraphs of the deed of trust in §§4.14-4.60. Certain other items that appear in a number of provisions of most deeds of trust, such as time limits and lender's discretion, are often the subject of negotiation between borrower and lender. A brief discussion of these common items follows in §§4.9-4.11. For a discussion of issues pertaining to negotiating loan documents from the borrower's point of view, see Carey, *Representing a Borrower in Commercial Real Estate Secured Financing*, 23 CEB Real Prop L Rep 158 (May 2000) [Part 1: Getting Started]; 23 CEB Real Prop L Rep 195 (July 2000) [Part 2: The Big Issues and More].

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§4.9 A. Time Periods

A deed of trust contains many time periods or limitations for taking certain actions. For example, there are time periods within which the borrower must do certain things, such as remediate hazardous contamination, and time periods for giving notice of certain events or occurrences. The borrower often views these time periods as too short, particularly for actions that depend on a third party or that can be affected by outside agencies.

EXAMPLE: Paragraph 24.7 of the deed of trust (in §4.89) provides that the borrower must remediate a hazardous contamination within 180 days after its discovery. The borrower can rightfully object to such a time limitation in advance because the nature of the contaminant, the involvement of state and/or federal agencies, permissions of local governments, and other factors are unknown. The borrower does not want to commit to a time period that may be impossible to comply with through no fault of the borrower. Lenders usually listen to such arguments when the action is not entirely within the borrower's control. Many lenders agree to alternative language stating that, as long as the borrower has begun the action (*e.g.*, remediating a hazardous contamination) within a certain time, diligently pursues the action, and continues to meet its monetary obligations, the borrower is not in default.

Lenders rarely negotiate the notice and cure periods for scheduled loan payments. Many lenders are flexible, however, on the time periods relating to other monetary obligations, such as reimbursing the lender's costs and curing mechanics' liens. See, *e.g.,* paragraph 9 in §4.74.

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§4.10 B. Lender's Discretion

An inherent question in most contractual negotiations is what standards to apply to one party's decisions when certain events will occur in the future. In the deed of trust, the lender—*not* the borrower—has the discretion to require certain actions in specified future situations or to consent to certain actions. For example, in the form deed of trust in §§4.62-4.117, there are 12 situations in which the lender has the right to decide something in its "sole and absolute" discretion, and only 2 in which the lender must use "reasonable" discretion. This issue of standards also arises in relation to actions of the borrower. The borrower is usually absolutely required to perform certain actions, but in a few situations the borrower need only perform the action if it is "commercially reasonable" or accords with industry practice. For example, a requirement that the borrower maintain earthquake insurance coverage may be conditioned on the premium for such insurance being "commercially reasonable" or such insurance being then customarily required by institutional lenders holding security interests in property comparable to, and in the vicinity of, the real property security.

PRACTICE TIP: It is in the borrower's best interest to limit the lender's discretion to at least a "reasonable" standard and to have the "commercially reasonable" standard for its own actions. The borrower's ability to soften the discretion standards largely depends on the parties' relative bargaining positions and the economics of the transaction. Lenders wish to have all their decision making be in their "sole and absolute" discretion because using terms such as "reasonable" or "commercially reasonable" creates issues of fact that the parties may not be able to resolve without litigation.

Consequently, lenders resist limiting their discretion to a reasonable standard except for matters that generally would not result in foreclosure if the borrower did not comply with the lender's demands, or in which the lender's discretion may be limited by law. For example, in the deed of trust, the only instances in which the lender conditions its discretion on reasonableness involve the application of insurance proceeds, which may be required by the implied covenant of good faith and fair dealing under *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57. See §4.27. Even when a lender is not required to be reasonable, the lender may find its freedom of action limited by the implied covenant of good faith and fair dealing.

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§4.11 C. Cost of Compliance

The institutional real property lender is in the business of lending money for a return that is greater than the cost of obtaining the money that is lent. Any extra costs incurred to protect the lender's security interest that were not anticipated when the loan was made will diminish the lender's return. Consequently, lenders typically require the borrower to pay such extra costs and, if they are not paid, the lender may pay them and add them to the loan balance. See, *e.g.,* §4.78. Such provisions are so common and generally reasonable that borrowers seldom negotiate them. The borrower may object, however, to paying certain cost items that seem discretionary with the lender.

EXAMPLE: Lenders may request the right to audit the borrower's books annually to confirm compliance with financial covenants and may require the borrower to pay for such audits. Borrowers may argue that audit costs are part of the normal business expense of servicing the loan, and that the lender should factor these costs into its expected return when making the loan. If this argument does not convince the lender to eliminate the payment requirement, the borrower should attempt to limit the cost to a reasonable number, *e.g.*, "not to exceed $500 per annual audit."

Lenders rarely limit the borrower's obligation to pay unanticipated costs that may be required if certain events occur or if the lender is put on notice of a possible threat to its security. Nevertheless, the borrower may argue that certain provisions appear to require the borrower to pay for unnecessary costs.

EXAMPLE: In paragraph 24.6 in §4.89, the lender may request an environmental audit of the real property security at the borrower's expense. The way the current provision is worded, the only limitation on this right is that the lender cannot request such an audit more often than annually. Although an annual audit may be reasonable for certain real property loans (*e.g.,* if the borrower's business uses hazardous materials on the property), annual environmental audits are generally not justified without a reasonable suspicion of hazardous contamination. Because environmental audits can be very expensive, the borrower may insist that the lender have a good faith reason for requiring them. The borrower may wish to limit such audits to situations in which contamination is suspected. This situation presents the issue of whether the lender must have a "reasonable" suspicion or whether the suspicion may be in the lender's "sole and absolute" discretion. See §4.47.

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§4.12 V. DRAFTING TIPS

Before word processing by computer, when documents were prepared on typewriters, changes to drafted documents meant either retyping the document or using whiteout or interlineation, often causing significant delays. Thus, many lenders preferred this practice because, to avoid delays, borrowers were less likely to request major changes to the lender's documents. With modern word processing and electronic delivery of documents, changes are easily made. The parties know this and realize that requesting changes in drafted documents no longer significantly delays the closing of the loan. Today, a document can be changed, e-mailed, and changed again within hours.

Some lenders try to minimize changes to their loan documentation by using either preprinted forms or document preparation software that limits changes. With preprinted forms, changes can still be made easily by using strikeouts and addendums, and a borrower should not hesitate to request changes for fear of delaying the closing beyond a crucial date.

Document preparation software may create more problems for borrowers desiring to change documents. These programs have only limited fields in which lenders can enter information, which generally includes only names, addresses, interest rates, and amounts. The body of loan documents is such that most of the provisions in the deed of trust cannot be changed. The borrower, however, may still request the deletion of objectionable provisions and the addition of an addendum with replacement provisions.

PRACTICE TIP: A borrower should understand that a lender using preprinted forms or document preparation software is doing so to save money, notably attorney fees. This saving may be reflected in the interest rate and the lender's loan fees. If the borrower requests changes, the lender may require the borrower to pay the lender's attorney fees for drafting the loan documents. The borrower should understand the tradeoff between getting a better provision on a subject such as insurance proceeds, which may never apply, and the additional costs of paying the lender's attorney to negotiate with the borrower's attorney. This advice applies equally to transactions that start with lender's counsel preparing the initial draft of the loan documents on a word processing system.

A conduit lender may be very reluctant to make any material changes in its documentation because nonstandard mortgages are difficult to sell at the price needed to meet the lender's yield expectations. Accordingly, changes in conduit loan documents may result in higher loan fees or interest rates and attorney fees.

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§4.13 VI. CROSS-COLLATERALIZATION

Cross-collateralization refers to situations in which a lender has made multiple secured loans to a single borrower and provides in the loan documentation that each piece of collateral is security for each loan (usually each promissory note). Cross-collateralization can be accomplished by referring to each obligation in each deed of trust (see §4.19). If one or more loans already exist so that their respective deeds of trust do not refer to all the loans, a cross-collateralization agreement adding secured obligations to the existing deeds of trust may be executed and recorded.

Cross-collateralization should not be confused with cross-default provisions. A cross-default provision makes a default under any one loan a default under another. In real estate lending, where a deficiency judgment is impracticable, if a borrower has several outstanding loans with a single lender secured by different real property, the borrower may believe that there is little or no equity in one particular property and may want to default on that loan so that the lender will foreclose on that property, leaving the borrower with the remaining property. With a cross-default provision, the borrower cannot stop payments on one loan without risking foreclosure on all loans.

Cross-collateralization and cross-default provisions achieve the same result by different means. Both provisions allow the deed of trust to be foreclosed because of a default on a preexisting or other nonprimary loan. Only cross-collateralization, however, allows the lender to get loan-to-value collateral support from multiple parcels of property and renders the cross-defaulted obligation a real property secured obligation that is subject to California's antideficiency and one-action rules. For a full discussion of those rules, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5 (4th ed Cal CEB 2009).

In contrast to cross-collateralization, a lender may secure a single loan transaction with multiple deeds of trust. Lenders should bear in mind that an election to conduct a trustee's sale on any one of the trust deeds will preclude a deficiency judgment even if some of the other security interests are extinguished by a senior foreclosure. See, *e.g., Oropallo v Oropallo* (1998) 68 CA4th 997, 80 CR2d 669. The lender may, however, conduct sequential nonjudicial foreclosures as long as it does not make a full credit bid. *Freedland v Greco* (1955) 45 C2d 462, 289 P2d 463; *Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 120 P2d 869. See Mortgage Deed of Trust Foreclosure §9.8. The *Oropallo* court also rejected the belief held by many family law practitioners that the antideficiency rules do not apply to trust deeds securing support or property equalization payments in marital dissolutions. On multiple security and multiple obligations, see Mortgage Deed of Trust Foreclosure, chap 9.

For a suggested cross-collateralization provision, see optional clause 1.12.6 in §4.66.

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VII. COMMERCIAL DEED OF TRUST

§4.14 A. Basic Form

A sample form of an institutional lender's commercial deed of trust is set forth in §§4.62-4.117. Being the lender's form, its provisions generally favor the lender. Sections 4.15-4.60 focus on why certain provisions are included and which ones tend to be negotiable, and suggest alternative language for some provisions.

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§4.15 B. Title of Document

The title of the document is necessary so that the recorder can properly index the document in the public records. The deed of trust form in §§4.62-4.117 includes an assignment of leases, an assignment of rents, and provisions that make the instrument a fixture filing and security agreement under the Uniform Commercial Code. Also, this deed of trust includes a request for notice provision for the borrower. All these elements are included in the title so that the deed of trust can be indexed under the separate headings.

NOTE: If the deed of trust secures a construction loan, to satisfy the requirements of CC §3097(j), the deed of trust must bear the designation "Construction Trust Deed" prominently on its face and state (1) the names and addresses of the lender and owner of the real property, and (2) the legal description and, if known, the street address of the property. *Romak Iron Works v Prudential Ins. Co.* (1980) 104 CA3d 767, 163 CR 869. Failure to comply with this requirement, however, does not affect the validity of the deed of trust. CC §3097(j). Subject to certain exceptions, for a construction deed of trust to obtain priority over security interests in personal property that becomes fixtures after recordation of the deed of trust, the deed of trust must indicate that it secures an obligation incurred for the construction of an improvement. Com C §9334(h). On construction loans, see chap 9.

Although not required by statutory law on commercial deeds of trust securing promissory notes with variable interest rates and balloon payment obligations, a few institutional lenders include language in the title to their deeds of trust notifying the borrower of these facts. For sample language, see option 1 in §4.63.

On adjustable rate mortgage loans (*e.g.,* those subject to 12 CFR §560.35), when the monthly payments may not cover all accrued interest, resulting in unpaid interest being added to the principal balance (negative amortization), a lender may wish to include a disclosure to that effect. For a form, see option 2 in §4.63. This disclosure gives fair warning to subsequent encumbrancers and purchasers that the prior encumbrance may increase, possibly diluting the security of the junior encumbrancer or the equity of the subsequent owner. In addition, if the deed of trust does not contain such disclosure, title companies will generally not issue a CLTA 111.8 endorsement (negative amortization endorsement; see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997)) or issue the policy of title insurance in an increased amount to cover the negative amortization.

See §§1.76-1.77, 3.11-3.13 for further discussion of adjustable rate notes.

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§4.16 C. Introductory Paragraphs

The first introductory paragraph states the date of the document, the parties' names, and the trustor/borrower's address. For form, see §4.63. The lender/beneficiary's address usually appears under the heading "After Recording Return To" in the upper left-hand corner, but it can also be put in this paragraph or in the notice paragraph of the deed of trust. See §4.107. The trustee's address is often the same as the institutional lender's but is occasionally for a company that conducts nonjudicial foreclosure sales. The actual address of the trustee, however, is rarely given in deeds of trust.

Another introductory paragraph of a deed of trust, the granting clause, contains the grant of the mortgaged property (see §4.18) to the trustee with power of sale. For form, see the first paragraph in §4.64. Reference to the power of sale is necessary to allow the trustee to proceed with a nonjudicial foreclosure sale if a default occurs. Without such a reference, the lender would have to rely on the rarely used judicial foreclosure proceeding. Even with a power of sale clause, the lender may choose judicial foreclosure to obtain a deficiency judgment. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 3 (4th ed Cal CEB 2009) for discussion of considerations in choosing judicial foreclosure.

The granting clause also contains a grant of a Uniform Commercial Code (UCC) security interest in certain defined property that may include personal property. For form, see first paragraph in §4.64. For that security interest to have priority over competing interests in the personal property, it must be perfected in the manner required under the UCC as enacted in the relevant state(s), *e.g.,* by filing a UCC financing statement or taking such other action as may be required by the UCC. See §§4.40, 7.21-7.42, 7.54.

NOTE: For certain special use properties, such as hotels, theaters, and nursing homes, some revenue (*e.g.,* snack bar sales or a portion of room charges attributable to amenities) may not be considered "rent." See *HUD v Hillside Assocs. (In re Hillside Assocs. Ltd. Partnership)* (BAP 9th Cir 1990) 121 BR 23 (money paid for care of nursing home patients not rent); *Financial Sec. Assur. Inc. v Days Cal. Riverside Ltd. Partnership (In re Days Cal Ltd. Partnership)* (9th Cir 1994) 27 F3d 374 (hotel room charges are rent, but revenues from sale of food and drink and other services are accounts); *Zeeway Corp. v Rio Salado Bank (In re Zeeway Corp.)* (BAP 9th Cir 1987) 71 BR 210 (gate receipts at race track not rent). See also 11 USC §§363(a), 552. A security interest in such revenue can be perfected only by filing a UCC-1 financing statement.

The final paragraph in the granting clause provides for an assignment of the rents (see discussion in §4.18; for form, see third paragraph in §4.64). Civil Code §2938 provides that a written assignment of an interest in rents, issues, and profits of real property made in connection with a loan secured by real property, regardless of how it is denoted (absolute or otherwise), is considered to be a present transfer of that interest on execution and delivery of the assignment and may be recorded. For discussion of assignments of rent with a form, see chap 5. On enforcement of assignments of rent, see Mortgage Deed of Trust Foreclosure, chap 6. For discussion of the handling of rents, see §4.33.

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§4.17 D. Definitions (Paragraph 1 of Deed of Trust)

In drafting real property loan documents, the modern practice is to include all the definitions at the beginning of each document. For form, see §4.66. Including the definitions in a single section makes them easier to find than if each term is defined in the first section in which it appears.

Some lenders use a document titled Loan Agreement, which is not recorded, to include many of the provisions found in the deed of trust, including a definition section, and include in the deed of trust a provision to the effect that capitalized terms used but not defined in the deed of trust have the meanings ascribed in the loan agreement. This method reduces the length of the deed of trust and helps avoid conflicting definitions in the various loan documents. If a separate loan agreement is used, it must be referenced in the deed of trust. For form, see optional language at the end of §4.66.

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§4.18 1. Fixtures, Improvements, Land, Leases, Mortgaged Property, Personalty, Rents

The defined terms Fixtures, Improvements, Land, Leases, Personalty, and Rents (see paragraphs 1.6, 1.11, 1.13, 1.14, 1.24, and 1.25 in §4.66, respectively) attempt to list all interests connected with the real property that the lender wishes covered by the lien of the deed of trust. These include future interests acquired by the trustor in the real property, easements, water rights, and all manner of personal property associated with commercial real property. These defined terms are then incorporated in the defined term Mortgaged Property, along with a multitude of other items associated with the ownership of real property, including any condemnation awards, insurance proceeds, plans and specifications, intellectual property rights, and tax refunds (see paragraphs 1.19.4, 1.19.7, 1.19.9, 1.19.10, and 1.19.11 in §4.66, respectively). Paragraph 1.19.5 includes the borrower's bank accounts with the lender as part of the Mortgaged Property. A lender who sets off a borrower's bank account that is not pledged as security for the loan runs the risk of losing its security interest in the real property unless it reverses the setoff. See *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201. On California's one-action and security-first rules, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 4 (4th ed Cal CEB 2009).

A general reference to fixtures should be sufficient for the lender's purposes because the fixtures that are important to the real property lender (*e.g.*, plumbing, elevators) are not likely to be subject to subsequently perfected priority under Com C §9334.

The enumeration of personal property in the defined term Personalty should be carefully reviewed for each loan to ascertain whether it lists all personal property customarily used in conjunction with the specific type of property secured that the lender wants included in its security package.

EXAMPLE: For hotel properties, Personalty should cover all revenue generated by the hotel from whatever source, furniture, fixtures, and equipment such as beds, televisions, linens, glassware, spa equipment, etc.

The lender should consider including antennas, satellite dishes, and other audio/visual or communications equipment and computer software and data.

The deed of trust should specifically assign and grant a security interest in any proceeds of a sale of the encumbered property (the definition of "Rents" in the form includes sales proceeds). A deed of trust on real property does not necessarily give the beneficiary any rights in sale proceeds. *In re Ehrle (Lin v Ehrle)* (Bankr 9th Cir 1995) 189 BR 771. In *Ehrle,* the Bankruptcy Appellate Panel suggested that a creditor could obtain a security interest in such sale proceeds through a personal property security interest.

Although a beneficiary may have its own cause of action for a third party's damage to the encumbered property, a deed of trust does not give the beneficiary any interest in the borrower's claims for such damage without the grant of a security interest in such claims. *American Sav. & Loan Ass'n v Leeds* (1968) 68 C2d 611, 68 CR 453. Accordingly, the deed of trust should specifically assign and grant a security interest in any claims, causes of action, and rights arising from damage to the encumbered property including, without limitation, claims for construction defects. For form, see §4.75.

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§4.19 2. Indebtedness and Obligations

The defined terms Indebtedness and Obligations list the monetary and other obligations that the deed of trust secures. Paragraph 1.12 in §4.66 defines Indebtedness to include the various monetary obligations the borrower has or may have in the future to the lender. The primary monetary obligation is the promissory note evidencing the initial loan for which the deed of trust is given as security (see paragraph 1.12.1). Also included as secured obligations in the definition of Indebtedness are the following:

- Monetary obligations under the deed of trust and other loan documents (see paragraph 1.12.2), including the charge for a beneficiary's statement (CC §2943);
- Other existing or future indebtedness owed to the lender by the borrower that are provided for under the loan documents (see paragraph 1.12.3) or that the parties specifically provide in an instrument are secured by the deed of trust (see paragraph 1.12.4); and
- Any changes to the included monetary obligations (see paragraph 1.12.5).

Paragraph 1.12.4 in §4.66 is a "future advance clause" as opposed to a "dragnet clause," which purports to subject every indebtedness between the lender and borrower to the lien of the deed of trust. The dragnet clause fell into disrepute because of the uncertainty it created over which debts would be included. To determine whether a debt not specifically secured by a deed of trust nevertheless was secured because of the existence of a dragnet clause, courts will look to (a) the relationship between the obligations, and (b) the reliance by the lender on the security that the lender seeks to bring within the scope of the dragnet clause. *Wong v Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 128 CR 338. In addition, there must be an objectively clear and unambiguous expression of the parties' mutual intent to collateralize the loan that the lender seeks to bring within the scope of the dragnet clause. *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162. This creates an unacceptable level of uncertainty for lenders using dragnet clauses, because they may not know whether a debt was secured under a dragnet clause until adjudication. If they exclude a particular debt from a judicial foreclosure action, they will be faced with the possibilities that, if the debt was later held to have been secured by the deed of trust, recovery on that debt would be barred by the one-action rule (CCP §726), or that, if they proceeded with a nonjudicial trustee's sale and did not include the debt in their credit bid, the antideficiency statute (CCP §580d) would prevent collecting on the excluded debt. *Union Bank v Wendland* (1976) 54 CA3d 393, 126 CR 549. On §726, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 4 (4th ed Cal CEB 2009); on the antideficiency rules, see Mortgage Deed of Trust Foreclosure, chap 5.

The defined term Obligations (paragraph 1.21 in §4.66) encompasses nonmonetary obligations secured by the deed of trust. These include performance of duties required by the loan documents, performance of the borrower's duties under a lease (*e.g.,* a ground lease that creates the estate the borrower is giving as security), and the performance of monetary obligations under covenants, conditions, and restrictions (CC&Rs) to which the real property is subject (*e.g.,* as in a condominium or a planned unit development). This defined term makes the borrower's enforcement of monetary obligations against other property owners covered by the same CC&Rs a secured obligation if the lender so requests. The borrower's enforcement of these obligations is important because failure to adequately fund reserves for common area maintenance and replacement would adversely affect the value of the lender's security. If the borrower's obligations under ground leases or CC&Rs are material to the loan transaction, then as an alternative to including them in the definition of Obligations, the practitioner may make them the subject of covenants of the trustor, the violation of which would be a default under the deed of trust.

PRACTICE TIP: A borrower should resist a broad definition of Obligations, particularly one creating a cross-default relationship between the borrower's obligations under, *e.g.*, any space lease and those under the loan.

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§4.20 3. Permitted Encumbrance(s)

The defined term Permitted Encumbrance(s) (see paragraph 1.22 in §4.66) specifies the exceptions to title that the lender will allow. Although institutional lenders often require the American Land Title Association (ALTA) Loan Policy with Form 1 coverage, amended as of October 17, 1970, title companies prefer issuing the newer ALTA Loan Policy with Form 1 coverage, dated October 17, 1992. The latter includes the creditors' rights exclusion, environmental regulation exclusion, and arbitration provision. Unless the lender does a substantial amount of business with the particular title company, the lender may not be able to obtain the 1970 policy form. For a comparison of the 1970 and 1992 forms, see California Title Insurance Practice, chaps 6, 8 (2d ed Cal CEB 1997).

Paragraph 1.22 provides that only current tax liens, liens in favor of or consented to in writing by the lender, and other items allowed by the lender can be listed as exceptions in Schedule B of the lender's title policy. The other items customarily allowed by lenders usually include utility easements and recorded CC&Rs containing appropriate mortgagee protection provisions. Whether the lender will permit other exceptions, such as leases, depends on many factors beyond the scope of this chapter. See Title Ins §§6.50-6.57. For a discussion of lender requirements in CC&Rs, see Forming California Common Interest Developments, chap 6 (Cal CEB 2004).

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§4.21 E. Covenants in Deed of Trust

The body of the deed of trust consists of covenants (agreements) between lender and borrower regarding the real property security and contractual rights and remedies. Some forms list these agreements under the headings Uniform Covenants and Nonuniform Covenants. However, "uniform" or "nonuniform" are not legally defined categories of covenants, such as express and implied, dependent and independent, or real and personal. Instead, they are carryovers from standard deed of trust forms prepared by secondary market lenders, *e.g.*, FNMA or FHLMC, for nationwide use. Uniform covenants are common to all states, and nonuniform covenants differ among the states, *e.g.*, foreclosure procedures. The deed of trust form in §§4.62-4.117 does not include a title for the covenants. Many of the covenants, such as the covenant to pay the principal and interest on the loan, are obvious and will not be discussed here. Some of the more important covenants are discussed in §§4.22-4.39.

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§4.22 1. Repair and Maintenance (Paragraph 2 of Deed of Trust)

The repair and maintenance provision in §4.67 recites the duties of the borrower, who is assumed in the deed of trust to be the property owner or ground lessee. A property owner concerned about the value of the real property would attend to most of the duties enumerated. Lenders largely rely on this natural desire of an owner to maintain its property. A breach of one of these repair and maintenance covenants, by itself, would rarely compel a lender to seek judicial enforcement or protection. In fact, a lender does not have an adequate judicial remedy for such breach short of starting foreclosure so that a receiver could be appointed to stop any waste. CCP §564(b). Lenders rarely begin foreclosure, judicial or nonjudicial, for other than a monetary default. As long as a borrower is current on the loan payments, minor deterioration of the property, even if known to the lender, typically results in no more than written and oral persuasion to repair and maintain the property. In practice, severe waste or deterioration is usually accompanied by monetary default, which soon leads to foreclosure. For discussion of lenders' remedies in waste situations, the impact of the antideficiency statutes, and bad faith waste under *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 5 (4th ed Cal CEB 2009).

Most of the duties set forth in this clause are not objectionable to a property owner and are seldom negotiated. A borrower may, however, wish to negotiate for the right to bond around any mechanics' lien claim in a dispute over right to payment. For form, see §4.103.

Paragraph 2(i) requires the borrower to retain professional property management if the lender so requires. Most borrower/owners of commercial property view the hiring of independent property management as an entrepreneurial decision to be made solely by the borrower, who is often highly qualified to act as a property manager. Most lenders abide by the borrower's decision on property management. Commercial lenders typically require third party management if the property is multifamily residential and the borrower is not an experienced manager of such property. The situations in which a lender would require independent property management are probably few compared with the number of commercial loans made using the lender's standard form. Most borrowers want to eliminate the third party management requirement, if possible.

PRACTICE TIP: If the borrower does employ a third party property manager, the lender may want to obtain an assignment of the management contract and will require that the contract be terminable, without penalty, on notice. This is usually a separate, unrecorded document that is executed by the borrower and the manager.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.23 2. Use of Mortgaged Property (Paragraph 3 of Deed of Trust)

§4.23 2. Use of Mortgaged Property (Paragraph 3 of Deed of Trust)

The covenant limiting the use of the property attempts to protect the lender against an adverse change in the real property security that may lower its value. Unless the lender consents, the deed of trust prohibits the borrower from converting the property to any use other than the one on which the lender based its loan. An exception to this prohibition would be a change required by law. For form, see §4.68.

DRAFTING CONSIDERATIONS: Given the rapidly changing commercial real estate market, borrower's counsel should attempt to define the permitted uses as broadly as possible. For example, permitted uses in apartment projects should include restaurants, gyms, concierge service, and, if possible, extended stay tenancies.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/ 3. Insurance (Paragraph 4 of Deed of Trust)/§4.24 a. Basic Requirements

3. Insurance (Paragraph 4 of Deed of Trust)

§4.24 a. Basic Requirements

The insurance provision in a deed of trust (see §4.69) generally

- provides for the types, forms, and amounts of insurance the lender requires the borrower to obtain;
- allows the lender to obtain the required insurance if the borrower fails to; and
- empowers the lender to take any necessary steps to collect the proceeds from the insurance company and deduct the cost of doing so.

For a discussion of the application of insurance proceeds after an insured loss, see §4.27. See also paragraph 1.19.7 in §4.66, which includes insurance proceeds as part of the definition of Mortgaged Property.

Lenders require the real property security to be insured for casualty loss under a standard building owner's policy (see paragraph 4.1.1 in §4.69) and require the borrower to have comprehensive general liability insurance (see paragraph 4.2 in §4.69).

This insurance is generally not negotiable except for the monetary limits of the comprehensive general liability insurance.

A typical insurance provision also

- requires the borrower to obtain specified hazard insurance for at least the amount of the loan (counsel for borrowers should recommend that the client consult with an insurance expert to ascertain whether the coverage required is adequate);
- requires that the policy be delivered to and retained by the lender;
- requires that the lender be made a loss payee; and
- informs the borrower that the lender is not responsible for inadequate insurance or the insurer's insolvency.

Lenders require a waiver of subrogation in any insurance policy obtained by the borrower that also protects the lender. The purpose of waiving subrogation is to avoid liability between the parties for claims compensated through insurance.

PRACTICE TIP: Lender's counsel should be sure that the lender's insurance specialists review all policies and all certificates of insurance. If this is not done, the lender could end up without coverage under the borrower's insurance.

Lenders are prohibited under CC §2955.5 from requiring hazard insurance coverage in an amount exceeding the replacement value of the improvements on the property. Before §2955.5 was enacted, lenders sometimes required hazard insurance in the amount of the loan even though it might exceed the replacement value of the improvements.

From the lender's perspective, the deed of trust should give the lender a security interest in all insurance proceeds, including those payable under a policy that the lender did not require. For sample language, see paragraph 1.19.7 in §4.66. This could also be done in the granting clause (see §4.16).

Paragraphs 4.4-4.5 in §4.69 provide standards for the minimum rating of the insurance company from which the insurance is purchased, the required endorsement on the policies (except the comprehensive general liability policy that covers bodily injury and property damage to third parties and not the mortgaged property itself), and the time periods for sending notice and receiving evidence of insurance. The 30-day time period for notice to the lender of termination of coverage is standard in insurance policies, and the borrower will not be able to change this.

The issue of insurance coverage and repair of the improvements in commercial loan situations can often involve the borrower's tenant or landlord (if the loan is on a leasehold) because of insurance and repair provisions of a lease.

PRACTICE TIP: Counsel for commercial borrowers should be aware of these potential interrelations. For example, if the borrower's tenant must obtain the insurance under a lease, counsel should make sure that the insurance is

satisfactory to the lender and will fulfill the borrower's obligation under the deed of trust.

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§4.25 b. Lender's Remedies for Borrower's Failure to Procure Insurance

If the borrower fails to procure insurance, the lender may purchase insurance and require reimbursement from the borrower (see paragraph 4.11 in §4.69). In this event, lenders usually obtain an interim binder until either they foreclose or the borrower obtains insurance. A lender that includes in the charge for replacement insurance any unrelated charges, *i.e.,* for administrative services provided to the lender, may be liable for violating unfair business practice laws (Bus & P C §§17200-17210). See *Gibson v World Sav. & Loan Ass'n* (2002) 103 CA4th 1291, 128 CR2d 19.

State and nationally chartered banks and their holding companies, state and federal savings associations and their affiliates, and their respective successors in interest, as well as persons authorized by the State of California to make or arrange loans secured by real property, may accelerate the loan and foreclose if the borrower fails to pay insurance premiums, regardless of whether the borrower's failure to pay premiums impaired the security interest. Fin C §§1227.2, 7461.

NOTE: Without a duty to make sure that a borrower's insurance is adequate, a lender cannot be liable to the borrower for negligence in failing to obtain sufficient insurance. *Brown v Department of Veterans Affairs* (1986) 178 CA3d 392, 224 CR 149.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.26 c. Additional Types of Insurance Required

§4.26 c. Additional Types of Insurance Required

Lenders require flood coverage if the property is in a special flood hazard area and flood insurance is available (see paragraph 4.1.3 in §4.69). Traditionally, institutional lenders did not require flood insurance. With the passage of the Flood Disaster Protection Act of 1973 (Pub L 93-234, 87 Stat 975), however, institutional lenders insured or supervised by a federal agency (including most banks and savings and loan associations) must require flood insurance on real property located in designated special flood hazard areas where federally subsidized flood insurance is available. 42 USC §4012a(b). Other than this special requirement, institutional lenders do not insist on individual flood insurance protection.

Paragraph 4 (in §4.69) also requires rent loss and business interruption insurance, boiler and sprinkler insurance, builder's risk insurance if there is construction on the property, and earthquake insurance (see paragraphs 4.1.2, 4.1.4, 4.1.5, and 4.1.6, respectively). The requirement for earthquake insurance is often negotiated. The lender has no right to receive proceeds of earthquake insurance policies insuring the mortgaged property unless the loan documents expressly requires the borrower to obtain such insurance. *Ziello v Superior Court* (1995) 36 CA4th 321, 42 CR2d 251. See also *Martin v World Sav. & Loan Ass'n* (2001) 92 CA4th 803, 112 CR2d 225 (lender entitled to control earthquake insurance proceeds when deed of trust did not specifically require earthquake insurance but provided that the lender was to be named loss payee if such insurance were obtained). Because earthquake insurance is either very expensive or unavailable, borrowers should normally object to a blanket requirement for earthquake insurance. The language of paragraph 4.1.6 requires the borrower to obtain earthquake insurance only if the lender requests it, in the exercise of the lender's business judgment based on certain factors. This provision still places a duty on the borrower to obtain earthquake insurance and is included when the lender has not required such insurance before closing the loan and merely reserves the right to request it in the future.

DRAFTING CONSIDERATIONS: A borrower could improve on the earthquake insurance provision by adding a condition that such insurance be available "on commercially reasonable terms." This phrase, however, invites a dispute over what is commercially reasonable, which may result in litigation if the lender does request earthquake insurance. See §4.10. As an alternative, the borrower could add the condition that such insurance be customarily required by other institutional lenders holding security interests in similar property, which many lenders are willing to accept. For form, see alternative language in paragraph 4.1.6. As another alternative, some lenders will agree not to require earthquake insurance unless a seismic study indicates the probable maximum loss (PML) rating of the property is greater than a specified percentage.

Since September 11, 2001, terrorism insurance has been a significant issue in commercial loans. In the wake of the enormous losses resulting from the attacks on the World Trade Center, most insurance companies began excluding from their property policies coverage for acts of terrorism. At the same time, most commercial lenders modified their loan documents to reserve to the lender the right to require coverage for perils of terrorism and acts of terrorists. The Terrorism Risk Insurance Act of 2002 (Pub L 107-297, 116 Stat 2322), which became effective November 26, 2002, establishes the Terrorism Risk Insurance Program under which the federal government will reimburse insurers for a significant amount of losses paid in each calendar year, above a certain threshold, resulting from acts of terrorism. This program will automatically expire on December 31, 2005. Pub L 107-297, §108, 116 Stat 2322. Insurers are initially required to make available coverage for losses resulting from acts of terrorism that does not differ materially from coverage for other losses, with respect to terms, amounts, and other coverage limitations. Pub L 107-297, §103(c)(1)(B), 116 Stat 2322. To qualify as an "act of terrorism," the event must be certified by the Secretary of the Treasury, in concurrence with the Secretary of State and the U.S. Attorney General, to meet certain requirements, must not be committed in the course of a war declared by Congress, and must result in property and casualty insurance losses exceeding $5,000,000. Pub L 107-297, §102(1), 116 Stat 2322. The Act should increase the availability and affordability of terrorism coverage, although it remains to be seen whether the resulting coverage and premiums will resolve the problem to the satisfaction of lenders and borrowers.

PRACTICE TIP: Borrowers should continue to negotiate to delete the terrorism insurance requirement or at least to condition it upon the coverage's being available at commercially reasonable rates. For form, see §4.69, optional paragraph 4.1.7, Alternative 1. Although lenders may argue that this is not necessary, because federal law mandates commercially reasonable rates (see Pub L 107-297, §103(c)(1)(B), 116 Stat 2322), it is not well understood how insurers translate this requirement into premiums and coverage. If the cost is substantial and the coverage minimal, borrowers will continue to resist terrorism insurance, particularly when the property by its nature or location is unlikely to be the target of, or affected by, acts of terrorism.

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4. Application of Condemnation Awards and Hazard Insurance Proceeds (Paragraph 5 of Deed of Trust)

§4.27 a. Impairment of Security

Paragraph 5 in §4.70 provides for application and payment of insurance proceeds or a condemnation award. Under this provision, if a total taking of the mortgaged property occurs, the condemnation award is applied to pay off the secured encumbrances before the borrower/owner receives any money. When there is damage to the improvements or only a partial taking, however, the implied covenant of good faith and fair dealing may prevent the lender from applying insurance or condemnation proceeds to pay down the loan except to the extent that its security is impaired. *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57 (insurance proceeds); *Milstein v Security Pac. Nat'l Bank* (1972) 27 CA3d 482, 103 CR 16 (condemnation award; now codified in CCP §1265.225). To date, California courts have not given a definitive answer on how to ascertain when a lender's security has been impaired. (The statutory definition of "impairment of security" in CCP §1265.230 is limited to that section, which applies only when there is a partial taking and a junior lien encumbers only part of the real property that is security for the senior lien.) In *People ex rel Dep't of Transp. v Redwood Baseline, Ltd.* (1978) 84 CA3d 662, 149 CR 11, the court suggested at least three alternative methods for measuring the lender's proper share of the proceeds of a partial taking. Paragraph 5.5 describes these three methods. The courts have not determined, however, whether a particular method can be selected in advance.

Paragraph 5.2 attempts to follow *Schoolcraft* for insurance proceeds but also covers the unresolved gray areas to the lender's advantage. For example, paragraph 5.2.1 allows the proceeds to be used to repair the property as long as certain conditions are met, including the conditions that the borrower not be in default and that the borrower diligently pursue the repairs, which must be authorized by the lender and be up to code.

PRACTICE TIP: The borrower should review the time periods set out in paragraph 5.2.1 to see whether they are sufficient for the borrower to take the necessary actions. See §4.9.

The lender is not required to use insurance proceeds to rebuild if the borrower is in default on the loan. *Ford v Manufacturers Hanover Mortgage Corp.* (9th Cir 1987) 831 F2d 1520. The borrower's default makes the value of the security irrelevant because the default impairs the beneficiary's security as a matter of law. Compelling the beneficiary to pay out insurance proceeds so that the buyer could rebuild would impair the beneficiary's contractual right to foreclose the lien.

NOTE: Because buyers of securitized mortgages do not want the note to be prepaid, the CMM form (see §4.2) *requires* rebuilding and does *not permit* prepayment if the property is damaged.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.28 b. Funds: Disbursement and Collection

§4.28 b. Funds: Disbursement and Collection

Paragraph 5.4 in §4.70 provides the lender with a fund either to reconstruct the improvements or pay off the loan if the improvements are destroyed or are taken by a government entity. Such a fund is clearly needed for a purchase money loan because the borrower could abandon the property after a loss, leaving the lender with inadequate security and no recourse against the borrower (CCP §580b) except to the extent the loss could be attributed to the borrower's bad faith waste. See *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557; California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 5 (4th ed Cal CEB 2009). Even in non-purchase-money situations, lenders require such a provision, and, except for the section on application, borrowers seldom object because they usually obtain insurance protection in any event.

Paragraph 5.2 allows the lender to hold insurance proceeds and disburse them as it would a construction loan. Financial Code §§1227.3 and 7462 state that a mortgage or deed of trust that authorizes a lender to receive and control the disbursement of the proceeds of any hazard insurance policy is enforceable whether or not the event insured against has impaired the security interest in the property. The legislature declared, however, that these statutes were not intended to abrogate the holding of *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57, insofar as it provides that a lender may not prohibit the use of insurance proceeds to restore the property unless the lender can show that its security was impaired. Stats 1987, ch 397, §5.

Paragraph 5.1 provides that the proceeds will be held in a non-interest-bearing account, although many lenders do allow an interest-bearing account (the same applies to condemnation awards).

PRACTICE TIP: Although the borrower will not be able to negotiate the right to receive the proceeds outright even if it has a duty to repair the improvements, the borrower should negotiate for at least a market rate of interest on the proceeds held by the lender. The borrower's argument is that the lender is still charging interest on the entire principal balance while it holds the proceeds, as opposed to a construction loan in which interest is charged only on the loan proceeds actually disbursed.

If the insured loss is slight and funds are insufficient to justify the lender's holding them and managing their disbursement, or if the partial taking is slight and the property's value is not affected, the lender may agree to release the proceeds to the borrower and rely on the borrower's duty to make any necessary repairs. See §4.22 and paragraph 4.12 in §4.69.

PRACTICE TIP: The borrower, to gain some assurance that the proceeds will be released, should negotiate for an automatic release if the damage or taking falls below a given dollar amount. The borrower should also negotiate for the right to receive the proceeds of larger claims when restoring the property makes sense from the lender's perspective and certain standards (*e.g.,* if the loan-to-value ratio meets a specified standard or the property, when restored, generates sufficient income to service the debt and cover other expenses). The borrower should also negotiate for the right to control claim settlements, because the lender does not have the same incentive to hold out for a large settlement. For larger claims, the lender is unlikely to give full settlement control to the borrower.

For a commentary on application of insurance proceeds, see Doyle, *Aftermath of a Fire: The Right of a Trust Deed Beneficiary to Control and Apply Insurance Proceeds*, 8 Cal Real Prop J 37 (Summer 1990).

Paragraph 5 in §4.70 gives the lender both a right to the condemnation award and the power to take the steps to secure it. Even without such a clause, the lender has a right to the condemnation funds, at least for a direct condemnation award. CCP §1265.220. See also Mortgage Deed of Trust Foreclosure, chap 8.

Paragraph 5.1 provides that the lender may join with the borrower in any suit or adjusting process necessary to collect the insurance proceeds or condemnation award. Normally, the lender relies on the borrower to collect the funds and uses these powers only when the borrower is not adequately pursuing recovery from the insurance company or condemning authority.

PRACTICE TIP: The borrower should try to negotiate for a provision that the lender may collect the proceeds or award only if the borrower fails to do so or fails to pursue collection diligently. The lender is unlikely to agree to this for claims above a certain threshold amount, *e.g.,* $100,000.

Paragraph 5.6 provides that application of the insurance proceeds or condemnation award does not affect the monthly payment amount or the due date.

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§4.29 5. Obligation to Pay Taxes and Other Sums Due (Paragraph 6 of Deed of Trust)

Paragraph 6 in §4.71 requires the borrower to pay all charges, *i.e.,* taxes, that have priority over the lien of the deed of trust if not paid, and other miscellaneous charges, including those described in the beneficiary statement mentioned in CC §2943(a)(2). This protection is necessary for the lender and, unless these charges are paid through impounds (see §§1.88, 4.34), is not subject to negotiation.

Civil Code §2924.7 permits express provisions in a deed of trust or mortgage authorizing acceleration of the loan and foreclosure if the trustor or mortgagor fails to pay any taxes, rents, assessments, insurance premiums, or specified advances as required, whether or not the lender's security interest in the property has been impaired. Section 2924.7 was enacted in 1989 to abrogate the holdings in *Kreshek v Sperling* (1984) 157 CA3d 279, 204 CR 30, and *Freeman v Lind* (1986) 181 CA3d 791, 226 CR 515, to the extent those holdings in any way restrict a beneficiary's right to enforce the express provisions of the deed of trust.

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§4.30 6. Leases of Mortgaged Property (Paragraph 7 of Deed of Trust)

In the commercial setting, borrowers often rent the encumbered property to third parties. The rent stream from such rentals is usually the basis for the property's value and is what the lender counts on as the borrower's source of funds to make the monthly loan payments.

PRACTICE TIP: The lender will want to perfect an assignment of these rents and have approval rights over the lease terms and any modifications. On assignment of rents generally, see chap 5.

Before making the loan, the lender reviews any existing leases to satisfy itself that the terms are acceptable. The lender will also decide whether it wants existing tenants to subordinate their leasehold estates to the lien of its deed of trust and whether it is willing to provide a subordinated tenant with a nondisturbance agreement. Retail Leasing: Drafting and Negotiating the Lease, chap 44 (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease, chap 28 (Cal CEB 1996).

Paragraph 7 in §4.72 gives the lender approval rights over any leases that the borrower enters into after the deed of trust is recorded. A borrower that will be using a standard lease form may want to submit it to the lender for preapproval so the borrower need only obtain approval of deviations from the preapproved form when the actual lease is submitted to the lender. Although borrowers often object to having to get prior approval, they understand that lenders have an interest in seeing that their security is not rented at below market rents or on commercially unreasonable terms that may affect the borrowers' ability to repay their loans.

PRACTICE TIP: For projects like shopping centers and office buildings, when leasing space is an ongoing, critical part of the business and competition for good tenants is often intense, the borrower should negotiate limits or conditions on the lender's approval rights so that lease transactions may be completed without delays. Parameters should be set for lease transactions that do not require approval, in terms of square footage, rental rates, term length, and other factors. For lease transactions requiring lender approval, the lender should be required to respond within a short period of time to avoid loss of tenants caused by the lender's delay. Optimally, the borrower should obtain a provision that the lender's failure to respond within the allotted time will be deemed consent to the proposed lease. A borrower's ability to obtain these concessions will depend, in part, on its size, experience, negotiating leverage, and the lender's experience with similar properties. Lenders may be persuaded by examples of how delays hurt the borrower's ability to attract good tenants and therefore negatively affect the project's cash flow.

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§4.31 a. Attornment Clauses

Paragraph 7 in §4.72 requires tenants to attorn to the lender after a foreclosure. Attornment is a tenant's recognizing the title of a stranger (the lender in this case) and denying the title of the tenant's original landlord (the borrower). Attornment must be made with the former landlord's consent unless it is in consequence of a judgment. CC §1948. This provision is actually intended to require a tenant to honor an existing lease in the lender's favor and at the lender's option. Without an enforceable attornment provision in the lease, if the lease is truly subordinate to the deed of trust, foreclosing on the deed of trust extinguishes the lease, and the tenant should be able to treat the lease as terminated and vacate the property.

Lenders are also concerned about the language in the attornment clause of the lease. See *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 77 CR2d 479. In some situations, the borrower may be able to limit the lender's preapproval right on this issue; lenders are generally not too concerned about short-term leases and often agree to forgo preapproval for short-term residential leases or leases of minimal amounts of space. For example, smaller tenants in a shopping center may not be a big concern of the lender.

In negotiating the preapproval right, borrower's counsel should point out that any new leases will be subordinate to the lien of the deed of trust and that a foreclosure by the lender will terminate those leases. Thus, the lender will not be faced with tenancies below market rents. *Dover Mobile Estates v Fiber Form Prods.* (1990) 220 CA3d 1494, 270 CR 183. The lender's response to this is that the below market rent may lead to foreclosure and that the lease's attornment clause does not necessarily terminate with the foreclosure of a senior lien. See *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman, supra*. See also *Vallely Inv. v BancAmerica Commercial Corp.* (2001) 88 CA4th 816, 106 CR2d 689 (discussing situations in which leases are not automatically terminated by lien foreclosure).

NOTE: Ideally, the lender wants to terminate any leases it does not want and keep leases it does want. To that end, paragraph 7 gives the lender the option of accepting or rejecting attornment.

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§4.32 b. Subordination of Lease to Deed of Trust

A lease is subordinate to the lien of a deed of trust if the lease was executed after the deed of trust was recorded. A lease is also subordinate to the lien of a deed of trust if an agreement specifically subordinates a prior lease to the deed of trust. This subordination can be in the form of an agreement entered into by the tenant, trustor, and beneficiary or it can be a lease provision stating that the lease is subordinate to any deed of trust or mortgage placed on the property. The lease in *Dover Mobile Estates v Fiber Form Prods.* (1990) 220 CA3d 1494, 270 CR 183, provided that it would be subordinate to any subsequent mortgage or deed of trust unless the mortgagee or beneficiary elected to have the lease be superior. The court held that this election was not made. The lease in *Aviel v Ng* (2008) 161 CA4th 809, 74 CR3d 200, provided that it would be subordinate to "future mortgages," but did not mention deeds of trust. The court held that "the function and purpose of deeds of trust and mortgages are identical, and except for the passage of title for the purpose of the trust, deeds of trust are practically and substantially only mortgages with a power of sale." 161 CA4th 816.

Lenders should also be aware of *Miscione v Barton Dev. Co.* (1997) 52 CA4th 1320, 61 CR2d 280, which held that the general rule that foreclosure of a deed of trust extinguishes a subordinate lease does not apply when the tenant contractually agreed to attorn to the lender after foreclosure and be bound by the lease. *Miscione* contains an interesting discussion of subordination, nondisturbance, and attornment agreements between lenders and tenants. For a more detailed discussion of *Miscione,* see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 6 (4th ed Cal CEB 2009); *Principal Mut. Life Ins. Co. v Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 77 CR2d 479 (attornment clause held enforceable because of express language in lease; lender entitled to enforce clause as third party beneficiary); Muñoz, *Miscione: A Monkey Wrench in Settled Law on Lender-Tenant Priorities*, 20 CEB Real Prop L Rep 124 (May 1997); Office Leasing: Drafting and Negotiating the Lease, chap 28 (Cal CEB 1996).

For further discussion of commercial lease subordination and sample agreements, see Retail Leasing: Drafting and Negotiating the Lease, chap 44, Apps G-H (Cal CEB 2007); Office Leasing, chap 28, Apps N-O.

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§4.33 7. Right to Collect and Receive Rents (Paragraph 8 of Deed of Trust)

Rents and profits are usually the source of funds for the monthly loan payments and are thus crucial to the value of commercial real property. A lender, wishing to obtain the benefits of the rents and profits, has the borrower assign them to the lender. See §4.16.

As a condition to making a loan, lenders could require the tenants of the mortgaged property to make their rental payments directly to the lender, who then deducts the payments and remits the difference to the borrower. But industry practice, the lender's unwillingness to collect and account for rent due to the administrative burden, and the lender's desire to avoid being considered a mortgagee-in-possession dictate that the lender not actually receive rents unless the borrower defaults. *Johns v Moore* (1959) 168 CA2d 709, 336 P2d 579. Most lenders, especially conduit lenders, use a "lock box" arrangement in which tenants deposit all rents into a bank account controlled by the lender or its agent. The funds are applied first to authorized expenses, such as scheduled loan payments, and any surplus is disbursed to the borrower. For further discussion of lock box arrangements, see §§1.45, 1.98.

Paragraph 8 in §4.73 provides that the lender, who has been assigned the rents, permits the borrower to collect and retain the rents unless a default occurs. The clause also provides that the lender need not take possession of the property before collecting rents and that the lender has no liability to the borrower for failing to collect rents after a default. Under CC §2938, a written assignment of interest in rents, issues, and profits of real property made in connection with a loan secured by real property, regardless of whether the assignment is denoted as "absolute," "absolute conditioned on default," "additional security for an obligation," or otherwise, is effective in creating a present security interest in existing and future leases of the property. Older forms of deeds of trust referred to the assignment of rents as being absolute because a difference was perceived between absolute and other denoted assignments before passage of the current version of CC §2938, which became effective January 1, 1997. For discussion of §2938, which governs the different types of assignments of rent executed on or after January 1, 1997, see §§5.3-5.9.

DRAFTING CONSIDERATIONS: Although this provision may seem highly favorable to the lender, CC §2938 substantially limits lenders' rights to enforce an assignment of rents. Borrowers rely on these limitations and generally do not try to negotiate the provisions on the assignment and handling of rents in the deed of trust.

Because most lenders do not want to actually collect rents unless the borrower has defaulted in making loan payments, the lender, who has been assigned the rents, grants the borrower permission to collect and retain them unless revoked by the lender. The lender has an absolute right to revoke this permission without cause by giving written notice. Consequently, default is not a necessary condition before the lender can obtain the rents, but a default automatically revokes the permission without the requirement of notice.

Although CC §2938 eliminated the need to put the assignment of rents in a separate recorded document, some practitioners still do so. For a separate assignment of rents form and discussion, see chap 5. For discussion of enforcement of assignment of rents provisions, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 6 (4th ed Cal CEB 2009).

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§4.34 8. Tax and Insurance Impounds (Paragraph 9 of Deed of Trust)

Paragraph 9 in §4.74 provides the lender, after an event of default (see §4.42), with a method of accumulating a fund that can be used to pay charges associated with the real property security when they become due. This method of collecting monthly, in advance, future tax payments and hazard insurance premiums is known as "tax and insurance impounds." Advance payments need not be limited to taxes and insurance. Some lenders' forms cover mortgage insurance premiums and ground rents if the security is a ground lease In a securitized loan using a CMM document (see §4.2), in addition to tax and insurance impounds, borrowers are often also required to set aside reserves for deferred maintenance. For negotiating techniques regarding reserves, see §1.89.

The depression of the 1930s led to the wide use of impounds by institutional lenders, and, until recently, most institutional lenders required the impound payments as a condition to making a loan, particularly on a single-family dwelling. This practice assured lenders that taxes and insurance premiums would be paid because it forced borrowers to budget for such payments. Moreover, lenders had use of the funds until the payments were actually due. This fact, however, was contested in borrower class actions in the 1970s, which claimed that the borrowers were entitled to the earnings on the impound payments held by the lender. Although the outcome of the litigation was mixed (compare *Abrams v Crocker-Citizens Nat'l Bank* (1974) 41 CA3d 55, 114 CR 913, and *McGhee v Bank of America* (1976) 60 CA3d 442, 131 CR 482 (not decisions on the merits), with *Marsh v Home Fed. Sav. & Loan Ass'n* (1977) 66 CA3d 674, 136 CR 180, and *Petherbridge v Prudential Sav. & Loan Ass'n* (1978) 79 CA3d 509, 145 CR 87 (decisions on the merits holding that lender could commingle funds and need not account or pay interest)), the legislature came to the aid of the homeowner/borrower with the amendment of CC §2954, effective January 1, 1974, to make impounds optional with the homeowner/borrower, except under specified conditions. See also CC §§2954.2, 2954.8, 2954.12.

The legislative curtailments on single-family home loan impounds led to less insistence on impounds with commercial loans, although lenders are less likely to require impounds on commercial loans in any event. Consequently, the impound requirement is usually conditioned on the borrower's being in default, as paragraph 9 in §4.74 provides. Because the provision requires an impound account if demanded by the lender once there is a default, the impound would continue even after the default is cured. Some courts strictly construe impound provisions, because a foreclosure usually results from the borrower's lack of compliance. See, *e.g.*, *Anolik v EMC Mortgage Corp.* (ordered not published Aug. 10, 2005; former opinion at 128 CA4th 1581, 28 CR3d 759).

PRACTICE TIP: The borrower may want to negotiate a change in this provision to permit discontinuance of the impound account after a default is cured and no further default occurs within a certain period of time.

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§4.35 9. Assignment of Causes of Action, Awards, and Damages (Paragraph 10 of Deed of Trust)

Paragraph 10 in §4.75 assigns to the lender claims and proceeds from claims the borrower may have against third parties, including claims not covered by the insurance and condemnation provisions. See §4.27. The provision covers more than claims for physical damage to the property so as not to be limited by *American Sav. & Loan Ass'n v Leeds* (1968) 68 C2d 611, 68 CR 453. *Leeds* held that a purchase money lender had no claim on proceeds the borrower received in settlement of the borrower's suit against the seller, alleging fraud in failing to disclose existing soil problems. The court denied the lender's claim to the proceeds because the suit was not one for property damage occurring after the borrower's acquisition of the property and, thus, was a risk assumed by the purchase money lender subject to CCP §580b.

PRACTICE TIP: The provisions of paragraph 10 rarely come into play, but the implied covenant of good faith and fair dealing would probably allow the lender to retain proceeds to the extent its security was impaired. Such clauses are unusual and are quite objectionable from the borrower's point of view. The borrower should negotiate for an impairment of security standard. (See paragraph 5.5 of §4.70 for three alternative ways of measuring impairment of security.) Lenders, to the extent they are damaged, would have independent actions against third party tortfeasors. *U.S. Fin. v Sullivan* (1974) 37 CA3d 5, 17, 112 CR 18.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.36 10. Protecting the Security; Litigation; Fees and Costs of Lender (Paragraphs 11 and 12 of Deed of Trust)

§4.36 10. Protecting the Security; Litigation; Fees and Costs of Lender (Paragraphs 11 and 12 of Deed of Trust)

Several of the deed of trust provisions contain language that allows the lender to protect its security by taking various actions and joining in or bringing litigation that may affect its security and its lien. Paragraphs 11 and 12 in §§4.76-4.77 are the prime examples of this right. Paragraph 11 requires the borrower to give the lender notice of any action that may affect the real property security and provides that the lender or trustee may intervene in such actions, but that, if it does not, the borrower must prosecute or defend the action. It also provides that both lender and trustee are entitled to attorney fees and costs actually incurred in any judicial or nonjudicial action in which the lender or trustee must retain an attorney. (Other provisions in the deed of trust (*e.g.*, condemnation, hazard insurance) also provide for the lender's attorney fees and costs. Civil Code §1717 generally gives the borrower reciprocal rights to attorney fees if there is a written agreement authorizing the lender to recover attorney fees.)

PRACTICE TIP: Although borrowers understand the lender's need to protect its security interest, they often object to such a provision because it requires the borrower to pay the lender's litigation costs and the borrower may end up paying both its own and the lender's litigation costs. The lender's primary purpose in having such a provision is to enable it to take steps to protect its security if it believes the borrower is not adequately doing so. Accordingly, although a lender will rarely agree to pay its own litigation expenses in litigation in which it becomes involved, the borrower may be able to negotiate a provision that allows the lender to join in or bring an action only when the borrower is not diligently pursuing protection of the security.

Paragraph 12 allows the lender to make payments or do other things it deems necessary to protect its security and, under paragraph 13, be reimbursed by the borrower or add the cost to the principal balance of the loan. These provisions cover the lender rights embodied in CC §2876 to satisfy senior liens and enforce payment from the borrower.

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§4.37 11. Sums Advanced to Bear Interest and to Be Secured by Deed of Trust (Paragraph 13 of Deed of Trust)

Paragraph 13 in §4.78 requires the borrower to reimburse the lender for any out-of-pocket expenses it may incur in exercising its rights under the deed of trust. If the borrower does not pay such amounts, they are added to the indebtedness and bear interest at the note rate from that date forward.

Paragraph 13 also states that advances by the lender are conclusively deemed to be mandatory, but any junior lienholders would not be bound by this provision. *Pike v Tuttle* (1971) 18 CA3d 746, 751, 96 CR 403; *Imhoff v Title Ins. & Trust Co.* (1952) 113 CA2d 139, 247 P2d 851. Payment by one lender of its borrower's obligation to others or to the lender for costs, when added to the loan, are in the nature of advances and can raise priority problems if there are junior liens of which the lender has actual knowledge. Payments to satisfy liens senior to that of the lender give the payments the priority of the lien satisfied (doctrine of equitable subrogation), and, in effect, are prior to the lender's own lien (*Windt v Covert* (1907) 152 C 350, 93 P 67). Other payments made to protect the security, *e.g.,* attorney fees, do not satisfy senior liens and do not subrogate the lender to a better or even equal priority position.

PRACTICE TIP: Because this clause makes the advances to protect the lender's security optional with the lender, junior lienholders could argue that such advances do not gain priority over their junior liens if the senior lender has actual notice of the junior liens. The lender making the payments would argue that such payments are necessary to protect the lender's security and should be considered obligatory advances, which would have the same priority as the original obligation. The lender could argue that, because the junior lienholder has notice of the lender's right to make such advances and the intention to treat the advances as obligatory at the time the junior lien is created, the junior is agreeing that its lien remains junior to such future advances, much as a junior remains junior to a modification of a senior loan when the junior has notice that the senior deed of trust has secured loan modifications. See *Friery v Sutter Buttes Sav. Bank* (1998) 61 CA4th 869, 72 CR2d 32. For discussion of optional and obligatory advances, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009).

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§4.38 12. Reciprocal Right to Attorney Fees

Real property lenders are made parties to all manner of actions, often solely because they hold a lien on real property that is the subject of litigation between other parties (*e.g.*, partition action between cotenants). The fees and costs of such actions become the obligation of the borrower under paragraphs 11 in §4.76 and 12 in §4.77 of the deed of trust and, combined with paragraph 13 in §4.78, can in effect be added to the original debt and secured by the deed of trust. This result has led one appellate court to apply CC §1717 (reciprocal right to attorney fees) in favor of a nonassuming successor to the original borrower, who had some equity in the property. *Saucedo v Mercury Sav. & Loan Ass'n* (1980) 111 CA3d 309, 168 CR 552.

Other than CC §2924c(c)-(d), which limits the amount of attorney fees that can be demanded during foreclosure proceedings, there is no guidance on the amount of fees for which a lender is entitled to be reimbursed. Most attorney fees clauses refer to "reasonable" fees, and most courts limit reimbursement to a reasonable amount.

PRACTICE TIP: What is a reasonable fee can be difficult to establish. The lender, who retains the attorney, will want reimbursement for the entire fee, while the borrower will often claim either that the lender did not really need to retain counsel, so reimbursement is unnecessary, or that the attorney performed and billed for services not covered by the attorney fees clause (or billed more than a reasonable amount), so reimbursement should be for less than the amount charged to the lender.

When the dispute for which the lender retained the attorney is litigated and terminated by settlement or judgment, the amount of attorney fees recoverable by the lender can be fixed in the settlement or judgment. If the dispute is not litigated, if litigation is dismissed without a judgment or settlement, or if the lender chooses not to seek attorney fees (see *De La Cuesta v Superior Court* (1984) 152 CA3d 945, 200 CR 1), the reimbursement issue remains unsettled. Unless the parties resolve the dispute amicably, the lender will simply claim the entire amount as part of the borrower's indebtedness. The borrower must either immediately seek an accounting in order to contest the amount, or do so later, when the borrower wishes to pay off the loan and obtain a reconveyance of the deed of trust. The lender's right to reimbursement for attorney fees is discussed in California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 8 (4th ed Cal CEB 2009).

Civil Code §1717 limits reciprocal rights to attorney fees. In *Flynn v Page* (1990) 218 CA3d 342, 266 CR 830, the court held that parties in pretrial dismissal cases must bear their own attorney fees, regardless of whether the claim for fees is based on a contract or on §1717 reciprocal rights. The entitlement to fees could be frustrated by an arbitration clause. *Moshonov v Walsh* (2000) 22 C4th 771, 94 CR2d 597.

For further discussion of attorney fees under CC §1717, see California Attorney Fee Awards, chap 6 (2d ed Cal CEB 1994).

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§4.39 13. Financial Statements; Estoppel Certificates (Paragraph 15 of Deed of Trust)

The income flow from commercial investment property is usually the borrower's source of funds to make its monthly payments. Commercial borrowers often negotiate "nonrecourse" loans, meaning that, subject to certain "carve outs," the borrower is not personally liable on the promissory note, and the lender must look solely to the real property for repayment in a default. In such cases, lenders are naturally concerned about the real property's being properly managed and economically sound. Paragraph 15 in §4.80 allows the lender to request financial data on the mortgaged property. Most out-of-state or conduit lenders will uphold financial reporting requirements of borrowers. A Capital Markets Mortgage (CMM; see §4.2), for example, requires detailed financial reporting, and conduit lenders take its provisions very seriously. It is becoming less common for institutional lenders to request financial data, but they must do so if a problem with the loan or the property is brought to their attention. If the lender requires that the financial reports be audited by lender personnel, the borrower may be able to negotiate limits on the amount it must pay for such audits.

This provision also requires the borrower to sign estoppel certificates, which are statements on the then-current status of the loan obligation and are often requested by parties interested in purchasing the loan. Paragraphs 15.4 and 15.5 allow the lender to obtain such a statement from the borrower, or, if the borrower refuses, allow the lender to provide the statement.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.40 F. Uniform Commercial Code Security Agreement (Paragraphs 16 and 17 of Deed of Trust)

§4.40 F. Uniform Commercial Code Security Agreement (Paragraphs 16 and 17 of Deed of Trust)

Paragraph 16 in §4.81 covers the common situation in which personal property security is taken in addition to real property security and a separate personal property security agreement is not used. To have priority over competing interests in the personal property, the security interest must be perfected in the manner required by the Uniform Commercial Code as enacted in the relevant state(s). For many types of collateral (*e.g.,* goods, accounts general intangibles), this is accomplished by filing a UCC financing statement in the state where the borrower is located. See Com C §9310(a)-(b), 9301(1), 9307, 9501; §§7.22-7.26, 7.34-7.35. Security interests in other types of collateral may require different perfection methods. See §§7.28-7.30. The rules for perfection of security interests in personal property and fixtures are discussed in detail in §§7.21-7.42. See §§7.26-7.51 for a separate security agreement form.

Unless there are specific types of personal property collateral, such as deposit or securities accounts, in which a security interest is to be granted, most real property lenders incorporate the personal property security provision into the deed of trust. A lender can either proceed with a unified real property foreclosure of both the personal and real property (subject to the limitation in *Aspen Enters. v Bodge* (1995) 37 CA4th 1811, 44 CR2d 763, that the real and personal property be "closely related") or conduct separate sales of each type of property (former Com C §9501(4)(a)(ii)-(iii)) regardless of whether the security agreement is incorporated into the deed of trust or separate security agreements were used.

PRACTICE TIP: The borrower should attempt to limit the lender's right to foreclose on the personal property. The borrower might try to obtain an agreement that any sale of the personal property be contemporaneous with the sale under the deed of trust. If the lender resists such a provision, the borrower may be able to get a separate agreement from the lender—one that applies only as long as the lender is the payee on the promissory note—by which the lender agrees not to hold a sale of the personal property before publication of a notice of sale.

Paragraph 17 in §4.82 provides that the deed of trust constitutes a fixture filing under Com C §9502(c). When the deed of trust constitutes a fixture filing, the normal 5-year effective period for financing statements (Com C §9515(a)) is extended until the deed of trust is released or satisfied of record, or its effectiveness otherwise terminates as to the real property (Com C §9515(g)).

For discussion of mixed collateral problems, see §7.17. See also *Kearns v Transamerica Home Loan (In re Kearns)* (BAP 9th Cir 2004) 314 BR 819, 823, aff'd (9th Cir 2006) 201 Fed Appx 473 (unpublished opinion) (when the borrower defaults on a loan secured by a residential deed of trust and a security interest in a vehicle, the lender's seizure and sale of the vehicle in accordance with Com C §9604 (1) does not constitute an "action" for purposes of the one-action rule of CCP §726, and (2) does not violate the security-first aspect of the one-action rule, and although §9604(a)(3)(e) provides that consumer loans are excepted from the safe harbor provided in 9604(a)(2), the terms of that safe harbor do not limit the order in which a lender may nonjudicially resort to mixed collateral under §9604(a)(1)); *Florio v Lau* (1998) 68 CA4th 637, 80 CR2d 409; California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009); Williams, *Mixed Collateral Foreclosures: New Turns on a Twisted Path*, 19 CEB Real Prop L Rep 116 (May 1996); Hetland & Hansen, *The "Mixed Collateral" Amendments to California's Commercial Code: Covert Repeal of California's Real Property Foreclosure and Antideficiency Provisions or Exercise in Futility?* 75 Cal L Rev 185 (1987).

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§4.41 G. Waiver of Statute of Limitations (Paragraph 18 of Deed of Trust)

The statute of limitations defense cannot be waived indefinitely. An attempted waiver, such as in Paragraph 18 of form 4.83-1, extends the statute for an additional 4 years. CCP §360.5. Under CC §2911, the lien of a deed of trust or mortgage is extinguished on the expiration of the 4-year limitations period under CCP §337(1). Civil Code §2911 provides for the extinguishment only of the right of judicial enforcement under CC §725a, and not the power of sale or the right to nonjudicial foreclosure. *Ung v Koehler* (2005) 135 CA4th 186, 196, 37 CR3d 311. For purposes of nonjudicial foreclosure, the lien of a deed of trust or mortgage expires on the later of either 10 years after the maturity date if the maturity date is ascertainable from the recorded evidence of indebtedness, or 60 years after recordation of the deed of trust if the maturity date is not ascertainable from the recorded evidence of indebtedness. CC §§882.020(a), 882.030; *Miller v Provost* (1994) 26 CA4th 1703, 33 CR2d 288. The inclusion of the maturity date in a notice of default does not make the maturity date ascertainable from the record for purposes of CC §882.020(a). *Ung,* 135 CA4th at 200. See also §4.6 and case comment on *Ung v Koehler* in 29 CEB Real Prop L Rep 251 (Mar. 2006). At the least, the filing of a lis pendens in an action for judicial foreclosure of the deed of trust extends the 10-year period under CC §882.020. *Slintak v Buckeye Retirement Co.* (2006) 139 CA4th 575, 43 CR3d 131.

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§4.42 H. Events of Default (Paragraph 19 of Deed of Trust)

Paragraph 19 in §4.84 lists the occurrences that are events of default under the deed of trust and that would allow acceleration of the loan and foreclosure. In addition to monetary defaults and the obvious breaches of the covenants and representations in the loan documents, the provision covers situations that can occur outside of the loan transaction, such as bankruptcy and adverse judgments against the borrower. The provision also includes the grace and cure periods for various defaults. Cure periods, like other time periods, are negotiated by the parties. See §4.9.

PRACTICE TIP: For monetary defaults before maturity, the borrower should not expect (1) notice and opportunity to cure or (2) more than a 5- to 10-day grace period. Some lenders, however, demand periods as short as 2 days. The grace period is often the same as the period before a late charge accrues. See §§3.15-3.17, 3.66. For nonmonetary defaults, the borrower should obtain longer cure periods.

California law provides a de facto cure period for monetary defaults by giving real property borrowers the right to reinstate a loan up to 5 business days before a nonjudicial foreclosure sale (or decree of foreclosure in judicial foreclosure) by curing the default. A borrower that reinstates the loan would also owe additional costs and fees, such as the statutory trustee's fee. See CC §2924c(b).

Breach of a representation or warranty is also an event of default. Institutional lenders sometimes have borrowers execute a separate document containing various written warranties and representations on, *e.g.*, authority to execute documents, absence of defaults, accuracy of financial statements, physical condition of the property, borrower's title, absence of hazardous or toxic wastes, compliance with governmental regulations, and other property-related representations in the deed of trust.

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I. Acceleration on Transfer or Encumbrance (Paragraph 20 of Deed of Trust)

§4.43 1. Due-on-Sale Clause

Paragraph 20 in §4.85 allows the lender to accelerate the maturity of the obligation if certain events occur. One such event is a transfer of the borrower's interest in the real property security, which is covered by the "due-on-sale" clause. The enforceability of these clauses is now governed by the Garn-St. Germain Depository Institutions Act of 1982 (Pub L 97-320, 96 Stat 1469), known as the Garn Act. The Garn Act §341 (12 USC §1701j-3) preempts all state laws, including judicial decisions limiting or restricting enforcement of due-on-sale clauses in real property loans, and provides that enforcement of these clauses is exclusively governed by the loan contract. Garn Act §341(b)(1) (12 USC §1701j-3(b)(1)).

Lenders have a limited ability to enforce due-on-sale clauses on residential and state law properties. See 12 CFR §591.5(b)(1); CC §2924.6.

NOTE: Civil Code §2924.6 does not require the 1-to-4 unit residential real property to be owner-occupied.

No regulatory limitations exist, however, on commercial properties. Commercial borrowers who know that they will soon transfer the property can usually get an exception to the clause for at least the first sale. For form, see second optional paragraph 20.3 in §4.85.

Another event triggering acceleration under paragraph 20 is the sale or transfer of 25 percent or more of the borrower's beneficial interests.

PRACTICE TIP: To maintain flexibility in its internal ownership and management structure, the borrower needs to be able to transfer equity interests in the borrower entity. For example, if the borrower is a limited partnership, it is important for the borrower to obtain the right to freely transfer the limited partners' interests. Furthermore, the holders of equity interests in the borrower may also need the flexibility to transfer interests for estate planning purposes (*e.g.,* into a trust). Most lenders will agree to some relief for the borrower under these circumstances.

Occasionally, the borrower intends to create a subsidiary or other entity to eventually hold title to the real property but has not done so at the time the loan closes. In that situation, the borrower wants the lender to agree in advance to the transfer. The lender will often agree to this if the principals of the borrower remain the same and the loan is nonrecourse. See §§1.51, 3.49-3.51. A provision for a one-time transfer from an existing borrower to a limited liability company to be formed by the borrower is in paragraph 20.3 in §4.85. Conduit lenders almost universally require the borrower to be organized as a single-purpose entity at the inception of the transaction as a condition of making the loan. For a detailed discussion of this requirement, see §1.96.

Historically, one purpose of the due-on-sale clause was to provide the lender with a means to accelerate the loan before its stated maturity date. When loans were typically for 30-year terms at a fixed interest rate, lenders wanted the ability to turn over the loans more often than every 30 years. The due-on-sale clause allowed this because real property tends to be transferred more often than every 30 years. With the typical commercial loan now being at a variable rate and for a short term (between 5 and 10 years), the need for a due-on-sale clause to accelerate the maturity is diminished. Consequently, some lenders are willing to delete the due-on-sale clause or at least give the borrower a limited right to have a new owner who satisfies the creditworthiness criteria assume the loan. Such a provision is in paragraph 20.4 in §4.85. However, borrowers should not expect flexibility from the lender in this regard with a construction loan.

Paragraph 22 in §4.87 requires the borrower to inform the lender of any transfer (as well as any other events of default).

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§4.44 2. Due-on-Encumbrance Clause

Paragraph 20 in §4.85 also contains a "due-on-encumbrance" clause, which restricts the borrower's right to further encumber the property. The lender's purpose in having this clause is to control the amount of debt the borrower secures with the property and prevent the borrower from reducing its equity in the property below an acceptable level. The enforceability of due-on-encumbrance clauses is probably limited to situations in which the lender's security will be impaired by the subsequent encumbrance. See *La Sala v American Sav. & Loan Ass'n* (1971) 5 C3d 864, 877, 97 CR 849.

PRACTICE TIP: As a substitute for this clause, the borrower should try to negotiate for a debt service coverage ratio (see §1.36) that, if met, will automatically permit additional encumbrances up to the level acceptable to the lender. Many lenders will agree to this. See Comment in §4.104. See paragraph 20.5 in §4.85 for a suggested provision. However, borrowers should also not expect flexibility from the lender in this regard with a construction loan.

NOTE: The Garn Act (see §4.43) may support, by negative implication, the enforceability of due-on-encumbrance clauses, except in the case of certain residential real property, despite *La Sala v American Sav. & Loan Ass'n, supra*. "Due-on-encumbrance" is not defined in the Garn Act or the OTS regulations. "Due-on-sale clause" is defined as "a contract provision which authorizes a lender, at its option, to declare due and payable sums secured by the lender's security instrument if all of any part of the property, or an interest therein, securing the real property loan is sold or transferred without the lender's prior written consent." 12 USC §1701j-3(a)(1). The OTS regulations, which are authorized under 12 USC §1701j-3(e)(1), define "due-on-sale clause" as "a contract provision which authorizes the lender, at its option, to declare immediately due and payable sums secured by the lender's security instrument upon a sale or transfer of all or any part of the real property securing the loan without the lender's prior written consent. For purposes of this definition, a *sale or transfer* means the conveyance of real property of any right, title or interest therein, whether legal or equitable." 12 CFR §591.2(b). However, the Garn Act prohibits exercise of rights under a due on sale clause if the security property is residential real property containing less than five dwelling units because of "the creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property." 12 USC §1701j-3(d)(1). That this prohibition was stated may imply that, had it not been stated, enforcing a due-on-sale clause on encumbrance is otherwise permissible.

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§4.45 J. Acceleration and Sale on Default (Paragraph 21 of Deed of Trust)

Paragraph 21 in §4.86 gives the lender the option to accelerate the loan if an event of default occurs (see §4.42). Events of default include specified adverse financial conditions of the borrower, such as voluntary and involuntary bankruptcy. Such provisions, called "ipso facto" or "bankruptcy" clauses, automatically terminate, or permit one contracting party to terminate, the contract in the event of the other party's insolvency or bankruptcy. The Bankruptcy Reform Act of 1978 (Pub L 95-598, 92 Stat 2549) limited such clauses by making them generally unenforceable for executory contracts and unexpired leases. 11 USC §365(e)(1).

Although bankruptcy clauses may still be enforceable in a deed of trust, bankruptcy courts do not favor them. That a borrower has suffered the type of financial reversal specified in the clause almost always means that the borrower is in monetary default. Accelerating the loan because of a monetary default is far more practical and judicially acceptable than using a bankruptcy clause for acceleration.

Paragraph 21 also summarizes how a nonjudicial foreclosure is conducted. Because the lender must strictly follow the statutes on nonjudicial foreclosures (CC §§2924, 2924h), this clause could not effectively provide for a different procedure. In this regard, the summary is more explanatory than controlling. If the clause gave the borrower rights in addition to the statutory scheme, however, the lender would have to honor the additional rights. See §3.35 (grace period allowed in promissory note). On nonjudicial foreclosures, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 2 (4th ed Cal CEB 2009). Civil Code §§2923.5-2924 impose additional requirements for notices of default and notices of sale with respect to owner-occupied residential loans. See §§4.60A-4.60B; Mortgage Deed of Trust Foreclosure §§10.7-10.8.

Paragraph 21 makes no reference to any rights the lender may have at common law. Before 1988, a lender's right to sue for fraud, regardless of the antideficiency statutes (CCP §§580a, 580b, 580d, and 726), was recognized in some situations (*Manson v Reed* (1986) 186 CA3d 1493, 231 CR 446) but not others (*First Fed. Sav. & Loan Ass'n v Lehman* (1984) 159 CA3d 537, 205 CR 600). Effective January 1, 1988, CCP §726 was amended to specifically permit an action by authorized parties for fraud in inducing the lender to make the loan despite the antideficiency statutes, with certain exceptions. CCP §726(f)-(g). Financial Code §§779 and 7460 also permit banks, savings associations, their affiliates and subsidiaries, and successors in interest, in certain situations, to sue for fraud despite the antideficiency statutes. See *Michelson v Camp* (1999) 72 CA4th 955, 85 CR2d 539 (lender who acquires mortgaged property by full credit bid is not barred from pursuing fraud action against third party nonborrower); *In re King St. Inv. (Hardin v Gianni)* (Bankr 9th Cir 1998) 219 BR 848 (lender not prohibited from seeking damages against debtor resulting from debtor's constructive fraud). On actions for fraud and the antideficiency statutes, see Mortgage Deed of Trust Foreclosure, chaps 4-5; on enforcing secured loans against debtors in bankruptcy, see Mortgage Deed of Trust Foreclosure, chap 11.

Paragraph 21 also contains a provision that creates a conclusive presumption in favor of a bona fide purchaser by virtue of recitals in the trustee's deed that the trustee has fulfilled its statutory notice requirements (*Melendrez v D & I Inv., Inc.* (2005) 127 CA4th 1238, 1250, 26 CR3d 413), but that presumption only applies to the propriety of required notices, and there is no statutory presumption that such recitals render effective a trustee's sale that had no contractual basis, *e.g.*, when there was no default by the debtor (127 CA4th at 1255; *Bank of America v La Jolla Group II* (2005) 129 CA4th 706, 713, 28 CR3d 825). A deed of trust can authorize the inclusion of nonstatutory recitals in a trustee's deed upon sale, and may state that the recitals will be deemed presumptively true at the time of the foreclosure. These recitals may include a statement that a default has occurred and has not been cured, but the effect of such a recital is not clear in light of CC §2953, which prohibits waivers of the borrower's rights at the time of or in connection with the making of or renewing of any real property secured loan (including, in particular, rights and privileges conferred under CC §§2924, 2924b, and 2924c). The authorization contained in the deed of trust might constitute an improper waiver of a right to show that the recital is factually untrue. 129 CA4th at 716. See Mortgage Deed of Trust Foreclosure §§7.61-7.63.

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§4.46 K. Waiver of Marshaling (Paragraph 23 of Deed of Trust)

"Marshaling" is a doctrine codified in CC §2899, which requires a foreclosing creditor with multiple security for the debt of a common borrower to foreclose first on any security in which no junior lien creditor has an interest, and then on the least encumbered property. A junior creditor of the common borrower, who has a security interest in some but not all of the same security as the foreclosing lender, may compel the foreclosing lender to proceed in this order of priority to protect the junior liens to the extent possible. A clause waiving the right to compel marshaling contained in a document executed only by the borrower and the lender would not affect a third party junior creditor. The waiver may be effective, however, when the original borrower, who waives marshaling, sells the security and takes back the loan, thus becoming a junior creditor. *Lyons v Security Pac. Nat'l Bank* (1995) 40 CA4th 1001, 48 CR2d 174. For a waiver of marshaling form, see paragraph 23 in §4.88.

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§4.47 L. Environmental Matters (Paragraph 24 of Deed of Trust)

Secured real property lenders are understandably averse to lending on property that may be contaminated or at risk of future contamination. Before making a commercial loan, lenders usually require the borrower to obtain at least a Phase I environmental report (see §1.65) on the subject property, the review of which is part of the lender's loan underwriting. As a matter of policy, some lenders refuse to lend on any property having hazardous contamination or having possible future contamination because of the borrower's business (*e.g.,* service station, dry cleaning plant, chemical company). Other lenders will lend on such properties, and some even specialize in contaminated properties. Special environmental insurance is available, but it is expensive.

Paragraph 24 in §4.89

- contains many of the borrower's representations about the property that relate to its present environmental condition and compliance with environmental law;
- contains covenants by the borrower that the borrower will not contaminate the property; and
- provides remedies in the event of contamination, including the obligation to clean up the contamination and indemnify the lender.

DRAFTING CONSIDERATIONS: Particularly when the loan is for the purchase of the property, borrowers want to limit their representations to either the borrower's "best knowledge and belief" or the knowledge disclosed in the environmental report provided to the lender at the loan origination. The provision limits the borrower's exposure in situations when the borrower is unlikely to have firsthand knowledge of past usage of the property, tenants' usage, or adjoining property conditions. Lenders typically resist this by asserting that the representations are intended to be a risk shifting device.

The indemnity obligation is phrased to survive the release of the deed of trust because the lender's actual exposure to environmental liability does not arise unless it forecloses, and it may then own the property itself. Most institutional lenders continue to rely on an indemnity secured by the deed of trust for protection before foreclosure and a separate unsecured springing indemnity for postforeclosure protection. Lenders have some protection against environmental liability once they purchase at their own foreclosure sale, but the existence of contamination often lessens the property's value, perhaps below the amount of the loan balance. Code of Civil Procedure §726.5 permits lenders who have made a loan secured by contaminated property to waive the security and sue the borrower on the note if a court finds that the property is "environmentally impaired," a term which means that clean-up costs exceed 25 percent of the fair market value of the security when the loan was made or the release or threatened release of the contamination was discovered, whichever is greater. See §8.85. Further, CCP §736 permits a lender under certain circumstances to sue the borrower for breach of a contract relating to any "environmental provisions" (see CCP §736(f)(2) for definition of "environmental provision") made by the borrower concerning the real property security, without foreclosing on, and without waiving, the security. See §8.85. See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 4 (4th ed Cal CEB 2009); California Real Property Sales Transactions, chap 7 (4th ed Cal CEB 2007).

See chap 5A; for a separate environmental indemnity form, see §5A.12.

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§4.48 M. Trustee, Power of Trustee, and Reconveyance (Paragraphs 25, 26, and 27 of Deed of Trust)

Paragraph 25 in §4.90 provides for the trustee's acceptance of its appointment. Although the trustee usually is not a signatory to the deed of trust, a named trustee in a trust agreement can accept appointment by knowingly exercising powers or performing duties under the trust instrument. Prob C §15600(a)(2). In institutional loans made by a California-based lender, the trustee is often a captive entity of the lender, and of course accepts appointment. When a title company is named as trustee, its acceptance is likely to arise from its knowledge and acquiescence in the transaction. A deed of trust provision stating that the trustee is deemed to accept its appointment when the deed of trust is recorded may not create acceptance if a third party trustee has no knowledge of the transaction, but this situation is unlikely to occur. A third party trustee who did object could easily be substituted out as trustee. See §4.49.

Paragraph 26 in §4.91 grants very broad powers to the beneficiary/lender and the trustee (if requested by the beneficiary) to do various acts without either notice or liability to the borrower. Institutional lenders realize that the exercise of many of these powers would be ineffective without the borrower's concurrence. For example, releasing security without the borrower's consent would create one-form-of-action problems (CCP §726; see *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298), and attempting to change the loan terms without consent would naturally be invalid. See *Badie v Bank of America* (1998) 67 CA4th 779, 791, 79 CR2d 273. The clause is actually intended to grant powers to the trustee to take various actions after the borrower has performed some act, *e.g.,* requesting a partial reconveyance under a valid release agreement. For further conditions to include in a partial release provision, see §4.60.

The trustee's duty to reconvey following full satisfaction of the secured obligation provided for in paragraph 27 in §4.92 is also a statutory duty (CC §2941), the breach of which is subject to penalties. Civil Code §2941(b)(2)-(3) provides two fallback procedures for a borrower's obtaining a reconveyance if the trustee or beneficiary fails to do so after satisfaction of the secured obligation. For discussion of a lender's liability under former CC §2941(e) (now CC §2941(d)) for failure to reconvey a deed of trust, see *Panagotacos v Bank of America* (1998) 60 CA4th 851, 70 CR2d 595, and *Prudential Home Mortgage Co. v Superior Court* (1998) 66 CA4th 1236, 78 CR2d 566. The first choice for the trustor, if the obligation has been satisfied for at least 60 days, is to request that the beneficiary substitute itself or another as trustee and issue the reconveyance. *Trustors Sec. Serv. v Title Recon Tracking Serv.* (1996) 49 CA4th 592, 56 CR2d 793. For the trustor, the least desired option (because the trustor must pay for it and may be required to indemnify the title company) allows a title company to prepare and record a "release of obligation" (the equivalent of a deed of reconveyance) if a reconveyance was not recorded within 75 days after the obligation was satisfied. CC §2941(b)(3); *Trustors Sec. Serv. v Title Recon Tracking Serv.*, *supra*.

Civil Code §2941 also provides that the beneficiary of a deed of trust has a duty to execute and deliver to the trustee the original note, deed of trust, and a request for a full reconveyance when the obligation secured by the deed of trust is satisfied. CC §2941(b)(1). Failure to timely deliver such documents to the trustee will make the beneficiary liable for damages and subject to a $500 penalty; see CC §2941(d); *Bartold v Glendale Fed. Bank* (2000) 81 CA4th 816, 97 CR2d 226.

To recoup the cost of reconveyance, trustees and lenders may charge the borrower a reasonable reconveyance fee, *State ex rel Bowen v Bank of America Corp.* (2005) 126 CA4th 225, 231, 23 CR3d 746, with a fee of not more than $45 being presumptively reasonable. CC §2941(e)(2).

For discussion of the title company's potential liability for recording a release of obligation, see *Cathay Bank v Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 266, 53 CR2d 595.

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§4.49 N. Substitution of Trustee (Paragraph 28 of Deed of Trust)

From time to time during the life of a loan, the lender may wish to substitute a new trustee for the existing one on a deed of trust because of, *e.g.,* a corporate change by the lender, the desire to substitute a foreclosure company to conduct a trustee's sale, or the existing trustee's refusal to act. Paragraph 28 in §4.93 provides for substituting a trustee by recording an instrument to that effect.

Even without such a clause, CC §2934a provides a method for substituting trustees, but the extensive notice provisions in that section have led lenders to rely on the simple substitution method specified in paragraph 28. On the parties' right to contract for a different substitution of trustee procedure and not have §2934a apply, see *U.S. Hertz, Inc. v Niobrara Farms* (1974) 41 CA3d 68, 83, 116 CR 44.

Substitution of trustees is usually of little concern to borrowers because trustees are basically only technical parties to the loan. The trustee may be a title company or may be wholly owned by the institutional lender; occasionally, the lender itself will act as trustee. Consequently, borrowers usually do not consider as a detriment the fact that they do not get actual notice of a substitution; however, the lender's failure to give notice of the substitution under CC §2934a can have adverse consequences on a nonjudicial foreclosure.

Before or concurrently with the recordation of the substitution of trustee, the lender must mail a copy of the substitution of trustee to all persons to whom mailing of a notice of default would be required (1) if a substitution of trustee is executed but not recorded before or concurrently with the recordation of a notice of default (CC §2934a(b)), and (2) if a substitution of trustee is effected after the recordation of the notice of default but before the recordation of the notice of sale (CC §2934a(c)). If the substitution is effected after the recordation of a notice of sale or the notice of sale does not otherwise contain the name, address, and telephone number of the substituted trustee and a new notice of sale containing that information is not given under CC §2924f, any sale conducted by the substituted trustee will be void. CC §2934a(e).

Civil Code §2934a provides an alternative procedure for execution of a substitution of trustee—by a majority of deed of trust beneficiaries. The procedure may be used if the deed of trust secures multiple notes in favor of multiple beneficiaries or if it secures a single note in which the beneficiaries have undivided interests "equivalent to a series transaction." CC §2934a(a)(1)(B).

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§4.50 O. Consents and Modifications (Paragraph 30 of Deed of Trust)

Paragraph 30 in §4.95 allows the lender, without affecting any guarantee or the existing priority, to modify certain loan terms without giving notice or obtaining anyone's consent and to modify the interest rate, amortization period, and monthly payment with only the borrower's consent. Although this clause may be binding on the nonborrower trustor, it is unlikely to constitute a waiver of the suretyship defenses of a nonsigning guarantor. CC §§2819, 3268. The clause should give notice to subsequent encumbrancers of a possible change (see *Friery v Sutter Buttes Sav. Bank* (1998) 61 CA4th 869, 72 CR2d 32), but it probably would not affect any rights of a subordinated lender (see *Gluskin v Atlantic Sav. & Loan Ass'n* (1973) 32 CA3d 307, 108 CR 318). Most guaranty agreements, however, require the guarantor to waive several otherwise available defenses. See chap 6 on guaranty agreements.

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§4.51 P. Waiver of Right of Offset (Paragraph 31 of Deed of Trust)

Under CCP §431.70, a borrower might have the right to offset, against payments due under the note, any other claims that the borrower might have, or have had, against the holder of the note that coexisted at a time when neither the borrower's claim nor the lender's rights under the note were barred by the statute of limitations. This right could prove particularly troublesome for a lender if, after a notice of default has been recorded, the borrower claims not to be in default because of the borrower's right to offset, against the amount in default, other claims the borrower may have against the note holder. These claims may not necessarily even relate to the secured debt. Paragraph 31 in §4.96 is an attempt to bar any offset, against payments due on the note, of any other claims the borrower may have against the note holder.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.52 Q. Future Advances (Paragraph 32 of Deed of Trust)

§4.52 Q. Future Advances (Paragraph 32 of Deed of Trust)

Paragraph 32 in §4.97 permits the lender to make optional future loans to the borrower and have them secured by the deed of trust. This would not give the lender lien priority for the optional future advance over existing recorded encumbrances of which the lender was actually aware when the advance is made, but it should give the lender priority for the advance against subsequent encumbrances. See *Friery v Sutter Buttes Sav. Bank* (1998) 61 CA4th 869, 72 CR2d 32.

PRACTICE TIP: In practice, a lender making an optional future advance obtains a title endorsement covering the advance. If the deed of trust does not have a future advance clause, the title company will require a recorded amendment or supplement to the deed of trust to disclose the future advance. The lender obtains the same relative priority by securing the additional loan with a new junior deed of trust. On future advance endorsements, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997).

On optional and obligatory advances, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009).

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§4.53 R. Prepayment (Paragraph 33 of Deed of Trust)

Provisions setting a premium, fee, or charge (the lender's terms) or a penalty (the borrower's term) for the lender's acceptance of a loan payment before it is due are standard in notes used by institutional real property lenders other than loans bearing interest at, *e.g.,* a prime-based rate or daily reset LIBO (or LIBOR) rate. In single-family home lending, such clauses have resulted in much litigation and are now regulated. See 12 CFR §§560.34, 591.5(b)(2)-(3); California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 8 (4th ed Cal CEB 2009).

Paragraph 33 in §4.98 states that, if the note contains a prepayment penalty, it will apply even if the lender accelerates the loan under the due-on-sale clause or if the borrower defaults. Despite this express language, a court might find that, in such an event, no prepayment of the note has occurred and refuse to enforce the prepayment penalty provision. See *Tan v California Fed. Sav. & Loan Ass'n* (1983) 140 CA3d 800, 189 CR 775. (The *Tan* court, however, held that the prepayment clause in question was not broad enough to apply to acceleration under a due-on-sale clause and indicated that a properly drafted clause might entitle the lender to impose a prepayment penalty under a due-on-sale clause.) But see CC §2954.10.

PRACTICE TIP: Paragraph 33 makes the payment of the prepayment charge a duty of the trustor and, coupled with the definition of Obligations (see §4.19), an obligation secured by the deed of trust. Prepayment clauses themselves are major subjects of negotiation in commercial lending. The borrower should try to obtain in the promissory note an exception from the prepayment charge provision if fire insurance or condemnation proceeds are used to pay down the loan.

Paragraph 33 also covers the collection of a prepayment fee when the borrower defaults and the lender elects to accelerate. Collection of a prepayment charge, if the loan documents so provide, was authorized in *Pacific Trust Co. TTEE v Fidelity Fed. Sav. & Loan Ass'n* (1986) 184 CA3d 817, 229 CR 269, and *Biancalana v Fleming* (1996) 45 CA4th 698, 53 CR2d 47. See Bernhardt, *Prepayment Pitfalls*, 19 CEB Real Prop L Rep 181 (Aug. 1996).

For an extensive discussion of prepayment clauses in promissory notes, see §§3.22-3.34; for forms, see §§3.87-3.94.

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§4.54 S. Additional Borrower Representations (Paragraph 34 of Deed of Trust)

Institutional lenders require borrowers to make certain representations about both the property and the borrower, *e.g.*, authority to execute documents, absence of defaults, accuracy of financial statements, physical condition of the property, borrower's title, absence of hazardous or toxic wastes (see paragraph 24 in §4.89), and compliance with governmental regulations. Institutional lenders also often require an opinion of borrower's counsel on some of these matters (see chap 8). Some lenders have borrowers execute a separate document containing the various written warranties and representations or include them in the loan agreement.

Paragraph 34 in §4.99 contains some of the usual representations that lenders want the borrower to make. A breach of any representation would be an event of default under the deed of trust (see §4.42), allowing the lender to foreclose.

On the lender's right to sue for fraud despite the antideficiency statutes, see §4.45.

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T. Miscellaneous Provisions

§4.55 1. Governing Law (Paragraph 35 of Deed of Trust)

Lenders often desire to have any litigation tried in the jurisdiction where their principal office is located. In dealing with real property, however, the court with jurisdiction is often the one where the property is located. The lender also wants to ensure that the law of the jurisdiction in which it is incorporated will apply. Federally chartered financial institutions often require that federal law will govern. For authority on choice-of-law clauses in secured transactions, see *Guardian Sav. & Loan Ass'n v MD Assocs.* (1998) 64 CA4th 309, 75 CR2d 151 (Texas choice of law may override CCP §580b in California foreclosure). *Guardian Sav. & Loan* is discussed further in §3.48. For form, see paragraph 35 in §4.100.

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§4.56 2. Request for Notice of Default (Paragraph 36 of Deed of Trust)

Even though the trustor is entitled to receive a copy of any notice of default or notice of sale by mail to the trustor's last known address (CC §2924b(b)(3)), the deed of trust should still contain a specific request for notice and the address to which the trustor wishes notices to be sent. Without such a clause in the deed of trust (or even with such a clause when no address is given), the lender must also publish or personally deliver notice (CC §2924b(b)(1)) unless the borrower has recorded a separate request for notice in the form provided for in CC §2924b(a). Government Code §27321.5(b) also requires that a mortgage with a power of sale or a deed of trust, to be recordable, must contain a request for a copy of notices of default and notices of sale and the addresses of the trustors.

Certain other persons, primarily successors in interest to the trustor, junior lienholders, state taxing agencies that have recorded notices of liens, and the Internal Revenue Service must receive mailed notice even if no request for notice is recorded. CC §2924b(c). The deed of trust could provide for mailed notice within a shorter period of time after the recordation of a notice of default or sale in addition to statutory notice. See also *Diamond Benefits Life Ins. Co. v Troll* (1998) 66 CA4th 1, 77 CR2d 581 (copy of notice of default need not be given to easement holders unless holder requests; CC §2924b(b)(2)).

PRACTICE TIP: Any person who would like to receive a copy of any notice of default or notice of sale under a deed of trust may record a request for notice using the form in CC §2924b(a). This procedure is particularly helpful to those who would not otherwise receive notice (*e.g.,* tenants with unrecorded leases or with leases prior in time to the recorded deed of trust).

Institutional deeds of trust universally contain a request for notice clause such as the one in paragraph 36 in §4.101, and such lenders, even if no such clause exists, are required to mail notices of default and sale to the borrower's last known address. CC §2924b(b)(1).

PRACTICE TIP: A borrower who has not met either of the requests for notice requirements of CC §2924b (having this clause in the deed of trust or recording separate request for notice), but who is in communication with the lender, could argue for an extension of the equitable estoppel argument, as in *Lupertino v Carbahal* (1973) 35 CA3d 742, 111 CR 112, in order to enjoin a foreclosure of which the borrower had no actual knowledge.

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§4.57 3. Delegation of Authority (Paragraph 48 of Deed of Trust)

Paragraph 48 in §4.113 provides that, when the deed of trust grants the lender the authority to act on the borrower's behalf (see §4.36), the delegation of authority is a "power coupled with an interest" and is irrevocable. An agency is normally created for the benefit of the principal (the borrower) and is revocable by the principal. When the agency is for the benefit of the agent (the lender), however, it is considered a power coupled with an interest, is irrevocable by the principal, and is not terminated by the principal's death or incapacity. See CC §2356(a). Because the purpose of appointing the lender as the borrower's agent is to allow the lender to protect its security, it would likely be considered a power coupled with an interest, even without paragraph 48. See *Todd v Superior Court* (1919) 181 C 406, 184 P 684.

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§4.58 U. Waiver of Right to Jury Trial (Paragraph 49 of Deed of Trust)

Institutional lenders infrequently depend on litigation to enforce their real property loans, except when it is necessary for the appointment of a receiver or if judicial foreclosure is necessary to preserve deficiency rights or to quiet title. These lenders ordinarily use nonjudicial foreclosure as their enforcement remedy and view litigation as likely to occur only if the borrower is trying to forestall a foreclosure.

If institutional lenders become involved in litigation brought by the borrower, they generally prefer a judge over a jury as the trier of fact, because they are concerned that juries may be biased against them, particularly if the borrower is an individual. In addition, they may prefer alternative dispute resolution over a trial because it is generally believed that resolution of disputes through arbitration and judicial reference is more expeditious and less expensive. Consequently, institutional lenders have required, as a condition to making the loan, a waiver of jury trial, an agreement to arbitrate disputes, or an agreement for judicial reference. The understanding that predispute jury trial waivers were enforceable in civil cases was founded on decisional law of the courts of appeal.

But in 2005, the California Supreme Court held that contractual predispute jury trial waivers are unenforceable. See *Grafton Partners LP v Superior Court* (2005) 36 C4th 944, 32 CR3d 5. The supreme court stated that under the California Constitution (Cal Const art I, §16), the right to a jury trial is inviolate and may only be waived in civil cases as permitted by statute. It observed that the legislature authorized jury trial waivers in civil cases by enacting CCP §631, which does not expressly mention predispute jury trial waivers and applies only if there is a pending court action. 36 C4th at 957. Even if the statute is ambiguous on this point, any ambiguity must be construed in favor of according a jury trial to a litigant. The court noted that predispute arbitration agreements and judicial reference provisions, both of which have the effect of waiving the right to a jury trial, are specifically authorized by statute, as required by the constitution. Such agreements are distinguishable from waivers of the right to jury trial in that they represent an agreement to avoid the judicial forum altogether. 36 C4th at 955. The court refused to limit its decision to contracts entered into after the decision date. Accordingly, jury trial waivers in existing contracts will not be enforced.

Although the validity of arbitration and judicial reference provisions was generally upheld in *Grafton Partners LP v Superior Court, supra* (see also *Woodside Homes v Superior Court* (2006) 142 CA4th 99, 47 CR3d 683), they may be independently challenged on the basis of unconscionability. See, *e.g., Trend Homes, Inc. v Superior Court* (2005) 131 CA4th 950, 32 CR3d 411; *Greenbriar Homes Communities, Inc. v Superior Court* (2004) 117 CA4th 337, 11 CR3d 371; *Villa Milano Homeowners Ass'n v Il Davorge* (2000) 84 CA4th 819, 102 CR2d 1.

For form of waiver and alternative clauses, see §4.115. For drafting strategies in the wake of *Grafton Partners,* see §§3.103, 6.88.

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V. Additional Provisions

§4.59 1. Leasehold Estate as Mortgaged Property

The standard deed of trust form in §§4.62-4.117 contains no provisions that would be necessary if the mortgaged property were a leasehold estate, *e.g.,* when the loan is on a lessee's interest under a ground lease. In that situation, the lender seeks protection against premature termination of the ground lease, which would eliminate the lender's security. Provisions to be added to the deed of trust would do the following:

- Forbid the lessee/borrower from adversely affecting the existing lease;
- Require the lessee/borrower to keep the lender informed of any default or action that might affect the leasehold interest; and
- Require the lessee/borrower to extend or renew the lease.

The last duty is necessary because institutional lenders may consider renewal terms on leases in calculating the maximum term allowable on the loan. See, *e.g.,* 12 CFR §560.3 (a loan secured by a leasehold interest is a "real estate loan" subject to federal regulation if "the term of the interest extends, or is subject to extension or renewal at the option of the [lender,] for a term of at least five years following the maturity of the loan"). The lender wants to make sure that the borrower exercises these renewals. The provisions would also require that, if the lessee/borrower obtains a greater estate in the real property (*e.g.,* the fee), the deed of trust will cover the after-acquired property interest. This provision should preclude the argument that, if the lessee/borrower did obtain the fee, the lesser estate (leasehold) would merge into the greater (fee), thus extinguishing the leasehold and, consequently, the lender's security.

In leasehold loans, unless the ground lease contains appropriate leasehold mortgagee protections, institutional lenders usually enter into a separate agreement with the lessee/borrower and the lessor, giving the lender the right, among other things, to receive notice of any defaults under the lease, to cure defaults, to otherwise step into the lessee's position, if necessary, to protect its security, and in any case to obtain an estoppel certificate from the lessor. See Geiger & Frobes, *Lenders and Leases*, 7 Cal Real Prop J 1 (Fall 1989).

For provisions to include in a deed of trust when the security is a leasehold estate, see §4.120.

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§4.60 2. Partial Release; Suretyship Waivers

Construction loans for large housing tracts require that the deed of trust provide for partial releases of security once homes are completed. (Such developments are usually "phased" (*i.e.,* there are limitations on new housing starts in the development based on inventory). The most common inventory limitations on new starts are "starts ahead of sales" and "starts ahead of closings." Under a starts-ahead-of-sales limitation, the borrower may not start any new construction if it would result in more than a specified number of units not being subject to contracts of sale meeting certain criteria. Under a starts-ahead-of-closings limitation, the borrower may not start any new construction if it would result in a total number of sold and unsold units in excess of a specified number. A key element of a partial release clause is the release price. Lenders are willing to release a home only for a price that is greater than the prorata amount of the loan the home represents, in order to have a cushion as homes are sold.

EXAMPLE: If there are 100 homes (all of the same value), the lender may require a release price of 1/90 of the loan, instead of 1/100 of the loan. This is known as an accelerated release price.

Release prices are sometimes contained in an exhibit to the deed of trust that lists the lot number of each home to be built and a dollar amount for the release price of each lot. The modern trend is to include the release price provision in the loan agreement, which avoids the need to record a modification of deed of trust if the release prices change. The total of the release prices is likely to exceed the total principal balance of the loan, but once the principal is paid off the lender would have to release the remaining lots in any event.

In addition to the release price, a partial release provision will condition the partial release on several other requirements, among which is the recordation of a Final Subdivision Map (also a requirement under the Subdivision Map Act; see California Subdivision Map Act and the Development Process, chap 7 (2d ed Cal CEB 2001)). Other common requirements are that the borrower not be in default and that the lender obtain a CLTA Endorsement No. 111 (see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997)). If the lender has issued a set aside letter, it will retain the right not to release all of the security property until the set aside letter has been returned. (A set aside letter is a letter that a construction lender may issue to a bonding company, often for a fee, agreeing to set aside a certain portion of the loan proceeds to be issued to the bonding company on satisfaction of the conditions to disbursement under the loan agreement if the bonding company is required to complete the subdivision improvements for which its bond provides financial security.) The provision in §4.121 is a typical partial release clause.

Suretyship waivers should be added to the deed of trust or put in a separate agreement if the trustor under the deed of trust is not also the obligor. For further discussion, see §4.3. For form waivers, see §4.122.

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§4.60A W. Perata Mortgage Relief Bill (SB 1137)

In 2008, concerned with rising foreclosure rates, the California Legislature passed the Perata Mortgage Relief Bill (SB 1137) (Stats 2008, ch 69). The new law (which sunsets on January 1, 2013, unless extended) imposes additional requirements for notices of default and notices of sale that are not described in the deed of trust. These additional requirements apply to all loans made between January 1, 2003, and December 31, 2007, secured by owner-occupied residential real property.

PRACTICE TIP: Practitioners should take care to ensure that what may otherwise appear to be a commercial loan is not subject to the SB 1137 protections because of the nature of the real property collateral. Nor should counsel assume that a court will not impose certain obligations of the bill on commercial lenders. See Geier, *The Perata Foreclosure Bill (SB 1137): New Rights for Defaulting Borrowers and Tenants; New Complications for Foreclosing Lenders,* 19 Miller & Starr Real Estate News Alert, No. 1, p 3 (Sept. 2008).

A notice of default for any applicable loan must include a declaration by the beneficiary that (CC §2923.5(b))

- the beneficiary has satisfied certain statutory contact requirements with the borrower;
- the beneficiary has tried with due diligence to contact the borrower in accordance with the statutory requirements; or
- the borrower has surrendered the property to the beneficiary.

If a notice of default with respect to a loan affected by these restrictions was filed before July 8, 2008, and there has been no subsequent notice of rescission, the notice of sale must include (CC §2923.5(c))

- a declaration that states either that the borrower was contacted to assess the borrower's financial situation and to explore options to avoid foreclosure; or
- in the event no contact with the borrower was made, a list of the efforts made, if any, to contact the borrower.

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§4.60B X. California Foreclosure Prevention Act

In 2009, the legislature passed the California Foreclosure Prevention Act (Stats 2009, 2d Extra Sess, ch 4, §3), further modifying the foreclosure process to "provide additional time for borrowers to seek loan modifications." The Act, which took effect on May 21, 2009, and will be automatically repealed on January 1, 2011, unless extended, provides that in order to allow the parties time to pursue a loan modification, the notice of sale may not be given until at least 90 days after the lapse of the 3-month period following the filing of the notice of default. CC §2923.52(a). The statute does not, however, specifically require that the lender enter into or even propose a loan modification. This requirement does not apply to loans (1) serviced by mortgage loan servicers that have a comprehensive loan modification program and have been exempted by the California Commission of Corporations, Department of Financial Institutions, or Department of Real Estate (CC §2923.53), or (2) made by or that are collateral for securities purchased by a California state or local public housing agency or authority (CC §2923.52(c)).

The timing requirements of §2923.52 also do not apply if (CC §2923.55)

- the borrower has surrendered the property;
- the borrower has contracted with a business or individual that advises people regarding how to extend the foreclosure process and avoid contractual obligations to lenders; or
- the borrower has filed bankruptcy under Chapter 7, 11, 12, or 13, and the bankruptcy court has not entered an order closing or dismissing the bankruptcy case or granting relief from the automatic stay.

A notice of sale must include a declaration from the mortgage loan servicer stating whether an exemption applies and whether the new timeframe for giving notice does not apply. Failure to comply with the notice of default and notice of sale requirements of CC §2923.52 or §2923.53 will not otherwise invalidate an otherwise valid foreclosure sale. CC §2923.54.

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§4.61 VIII. SATISFACTION OF THE OBLIGATION

When the borrower satisfies all obligations secured by a deed of trust, the deed of trust must be released or, technically speaking, the property must be reconveyed from the lien of the deed of trust. If the borrower (or its successors) makes a written request, the lender must deliver the original note and deed of trust to the borrower unless one of the circumstances in CC §2941(b)(7)-(8) applies. CC §2941(a). See §4.48. The obligations that must be satisfied for the deed of trust to be reconveyed need not be only repayment of the secured loan. *Dieckmeyer v Redevelopment Agency of the City of Huntington Beach* (2005) 127 CA4th 248, 258, 24 CR3d 895 (borrower who has prepaid loan is not entitled to reconveyance of deed of trust when deed of trust secures both loan and certain unfulfilled promises of the borrower relating to affordable housing restrictions).

On satisfaction of the secured obligations, the lender executes and delivers to the trustee a form titled Request for Full Reconveyance, together with the original note and deed of trust. The trustee then executes and records a form fully reconveying the property. The full reconveyance typically reconveys the property to "the person or persons legally entitled to the Mortgaged Property" (see third sentence in §4.92). Lenders often streamline this process by executing and recording a substitution of trustee and full reconveyance form, which substitutes the lender as the trustee under the deed of trust and then reconveys the property. See §4.49 on substitution of trustees.

Civil Code §§2939-2941.7 set forth the requirements for releasing a mortgage or deed of trust. The lender may charge the borrower a reasonable fee for the release (the statutory amount is conclusively presumed to be reasonable) as well as the official fee for recording it. CC §2941(e). See also *State ex rel Bowen v Bank of America Corp.* (2005) 126 CA4th 225, 232, 23 CR3d 746. It is not entirely clear whether §2941(e) is self-operative. Accordingly, the deed of trust should specifically provide for the payment of these fees (see §4.92). See *Bloom v Martin* (9th Cir 1996) 77 F3d 318 (lenders' failure to disclose that demand and reconveyance fees would be assessed when borrowers later sold their homes and prepaid loans did not violate Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-2617) and, in any event, borrowers were notified of such fees at time of purchase because fees were described in deeds of trust executed at closing).

In one case, a bank that, following payoff, timely executed and delivered reconveyance documents to a title company acting as escrow holder did not fail to comply with CC §2941(b). *Serafin v First Interstate Bank* (1997) 58 CA4th 785, 68 CR2d 297. In another case, a lender that failed to properly reconvey within the statutory time period under CC §2941 was liable for the then $300 (now $500) statutory penalty but, on the particular facts of the case, avoided a claim for compensatory damages for alleged interference with another transaction. *Panagotacos v Bank of America* (1998) 60 CA4th 851, 70 CR2d 595.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/ IX. COMMERCIAL DEED OF TRUST FORM/ A. Introductory Paragraphs/§4.62 1. Form: Recording Format

IX. COMMERCIAL DEED OF TRUST FORM

A. Introductory Paragraphs

§4.62 1. Form: Recording Format

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.

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4.62-1 Recording format

Recording Requested by)
After Recording Return to)
)
)
)
)
)
_____)

(Space above this line for recorder's use)
_____

Attn: _____

Loan No.: _____

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.63 2. Form: Title; Parties

§4.63 2. Form: Title; Parties

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4.63-1 Title; parties

DEED OF TRUST, ASSIGNMENT OF LEASES AND RENTS, FIXTURE FILING, AND SECURITY AGREEMENT; REQUEST FOR NOTICE

[*If applicable, consider adding this notice*]

[*Option 1: Disclosure of variable interest and balloon payment*]

NOTICE TO BORROWER: THE LOAN SECURED BY THIS DEED OF TRUST PROVIDES FOR A VARIABLE INTEREST RATE AND BALLOON PAYMENT AT MATURITY

[*Option 2: Disclosure of negative amortization*]

NOTICE TO BORROWER: THE LOAN SECURED BY THIS DEED OF TRUST PROVIDES FOR CHANGES IN THE INTEREST RATE AND/OR MONTHLY PAYMENT, WHICH MAY RESULT IN UNPAID INTEREST BEING ADDED TO THE PRINCIPAL BALANCE OF THE LOAN.

[*Continue*]

This Deed of Trust, Assignment of Leases and Rents, Fixture Filing, and Security Agreement (Deed of Trust) is made as of _ _[*date*]_ _, among _ _[*name*]_ _, LLC, a California limited liability company, as trustor (Borrower), whose address is _ _[*address*]_ _; _ _[*name*]_ _, a California corporation, as trustee (Trustee); and _ _[*lender*]_ _, a _ _[*specify entity*]_ _, as beneficiary (Lender).

Comment: The disclosure in option 1 is generally required (in 10-point type) for variable interest rate loans on single-family residences (four or fewer units) made by lenders other than "supervised financial organizations" (state and federally regulated banks, savings associations, savings banks, credit unions, state regulated industrial loan companies, licensed finance lenders under the California Finance Lenders Law, licensed residential mortgage lenders under the California Residential Mortgage Lending Act, institutions of the Farm Credit System or holding companies, affiliates, or subsidiaries of any of these organizations). CC §1916.5(a). The disclosure is found on some commercial deed of trust forms because the forms are often also used for spot construction loans on single-family homes. Title companies typically require that this disclosure be included in the deed of trust as a condition to issuing the CLTA Form No. 111.5 endorsement (variable rate mortgage endorsement). On title of document and use of this optional notice, see §4.15. On lender endorsements, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997).

On use of option 2, see §4.15.

When the trustor under the deed of trust is not the borrower (the maker of the note), the trustor is a surety for the borrower. In this event, "Borrower" in the deed of trust should be replaced by "Trustor." See §4.3. For form of suretyship waivers to use in this situation, see §4.122. On first introductory paragraph, see §4.16.

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§4.64 3. Form: Grant of Mortgaged Property; Execution of Documents; Assignment of Rents

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.

▶ To download **Word** version, right click and choose *Save Target As*

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4.64-1 Grant of mortgaged property; execution of documents; assignment of rents

To secure the full and timely payment of the Indebtedness and the full and timely performance and discharge of the Obligations, Borrower GRANTS, BARGAINS, SELLS, AND CONVEYS to Trustee the Mortgaged Property, with power of sale and right of entry, subject only to the Permitted Encumbrances, to have and to hold the Mortgaged Property to Trustee, its successors in trust, and the Trustee's assigns forever, and Borrower does hereby bind itself, its successors, and its assigns to warrant and forever defend the title to the Mortgaged Property to Trustee against anyone lawfully claiming it or any part of it; provided, however, that if the Indebtedness is paid in full as and when it becomes due and payable and the Obligations are performed on or before the date they are to be performed and discharged, then the liens, security interests, estates, and rights granted by the Loan Documents shall terminate; otherwise, they shall remain in full force and effect. As additional security for the full and timely payment of the Indebtedness and the full and timely performance and discharge of the Obligations, Borrower grants to Lender a security interest in the Personalty, Fixtures, Leases, and Rents under Article Nine of the Uniform Commercial Code in effect in the State of California. Borrower further grants, bargains, conveys, assigns, transfers, and sets over to Trustee, acting as both a trustee and an agent for Lender under this Deed of Trust, a security interest in and to all of Borrower's right, title, and interest in, to, and under the Personalty, Fixtures, Leases, Rents, and Mortgaged Property (to the extent characterized as personal property) to secure the full and timely payment of the Indebtedness and the full and timely performance and discharge of the Obligations.

Borrower agrees to execute and deliver, from time to time, such further instruments, including, but not limited to, security agreements, assignments, and UCC financing statements, as may be requested by Lender to confirm the lien of this Deed of Trust on any of the Mortgaged Property.

Borrower further irrevocably grants, transfers, and assigns to Lender the Rents. This assignment of Rents is to be effective to create a present security interest in existing and future Rents of the Mortgaged Property under California Civil Code §2938.

Comment: On granting clauses and other introductory paragraphs, see §4.16.

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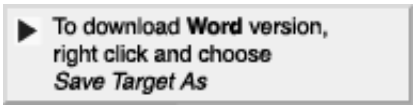
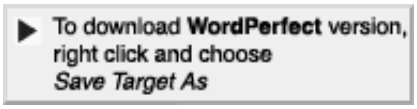
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.65 4. Form: Borrower's Covenants

§4.65 4. Form: Borrower's Covenants

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.





4.65-1 Borrower's covenants

TO MAINTAIN AND PROTECT THE SECURITY OF THIS DEED OF TRUST, TO SECURE THE FULL AND TIMELY PERFORMANCE BY BORROWER OF EACH AND EVERY OBLIGATION, COVENANT, AND AGREEMENT OF BORROWER UNDER THE LOAN DOCUMENTS, AND AS ADDITIONAL CONSIDERATION FOR THE INDEBTEDNESS AND OBLIGATIONS EVIDENCED BY THE LOAN DOCUMENTS, BORROWER HEREBY COVENANTS, REPRESENTS, AND AGREES AS FOLLOWS:

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.66 5. Form: Definitions

§4.66 5. Form: Definitions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.

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4.66-1 Definitions

1. Definitions. For purposes of this Deed of Trust, each of the following terms shall have the following respective meanings:

1.1. "Attorney Fees." Any and all attorney fees (including the allocated cost of in-house counsel), paralegal, and law clerk fees, including, without limitation, fees for advice, negotiation, consultation, arbitration, and litigation at the pretrial, trial, and appellate levels, and in any bankruptcy proceedings, and attorney costs and expenses incurred or paid by Lender in protecting its interests in the Mortgaged Property, including, but not limited to, any action for waste, and enforcing its rights under this Deed of Trust.

1.2. "Borrower." The named Borrower in this Deed of Trust and the obligor under the Note, whether or not named as Borrower in this Deed of Trust, and subject to _ _[*e.g., paragraph 19*]_ _ and _ _[*e.g., paragraph 20*]_ _ of this Deed of Trust, the heirs, legatees, devisees, administrators, executors, successors in interest to the Mortgaged Property, and the assigns of any such person.

1.3. "Default Rate." The Default Rate as defined in the Note.

1.4. "Event of Default." An Event of Default as defined in _ _[*e.g., paragraph 19*]_ _ of this Deed of Trust.

1.5. "Environmental Laws." Any Governmental Requirements pertaining to health, industrial hygiene, or the environment, including, without limitation, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) as amended (42 United States Code §§9601-9675); the Resource Conservation and Recovery Act of 1976 (RCRA) (42 United States Code §§6901-6992k); the Hazardous Materials Transportation Act (49 United States Code §§5101-5128); the Federal Water Pollution Control Act (33 United States Code §§1251-1387); the Clean Air Act (42 United States Code §§7401-7671q); the Toxic Substances Control Act (15 United States Code §§2601-2692); the Refuse Act (33 United States Code §§407-426p); the Emergency Planning and Community Right-To-Know Act (42 United States Code §§11001-11050); the Safe Drinking Water Act (42 United States Code §§300f-300j); the California Hazardous Waste Treatment Reform Act of 1995 (Stats 1995, ch 638 (SB 1222-Calderon)); the California Unified Hazardous Waste and Hazardous Materials Management Regulatory Program (Stats 1993, ch 418 (SB 1082-Calderon)); the Carpenter-Presley-Tanner Hazardous Substance Account Act (Health and Safety Code §§25300-25395.45); the California Expedited Remedial Action Reform Act of 1994 (Health and Safety Code §§25396-25399.2); and the Porter-Cologne Water Quality Control Act (Water Code §§13000-14958).

1.6. "Fixtures." All right, title, and interest of Borrower in and to all materials, supplies, equipment, apparatus, and other items now or later attached to, installed on or in the Land or the Improvements, or that in some fashion are deemed to be fixtures to the Land or Improvements under the laws of the State of California, including the California Uniform Commercial Code. "Fixtures" includes, without limitation, all items of Personalty to the extent that they may be deemed Fixtures under Governmental Requirements.

1.7. "Governmental Authority." Any and all courts, boards, agencies, commissions, offices, or authorities of any nature whatsoever for any governmental unit (federal, state, county, district, municipal, city, or otherwise) whether now or later in existence.

1.8. "Governmental Requirements." Any and all laws, statutes, codes, ordinances, regulations, enactments, decrees, judgments, and orders of any Governmental Authority.

1.9. "Hazardous Substance." Any and all (a) substances defined as "hazardous substances," "hazardous materials," "toxic substances," or "solid waste" in CERCLA, RCRA, and the Hazardous Materials Transportation Act (49 United States Code §§5101-5128), and in the regulations promulgated under those laws; (b) substances defined as "hazardous wastes" in California Health and Safety Code §25117 and in the regulations promulgated under that law; (c) substances defined as "hazardous substances" in California Civil Code §2929.5; (d) substances listed in the United States Department of Transportation Table (49 Code of Federal Regulations §172.101 and amendments); (e) substances defined as "medical wastes" in the Medical Waste Management Act (Chapter 6.1 of the California Health and Safety Code); (f) asbestos-containing materials; (g) polychlorinated biphenyl; (h) underground storage tanks, whether empty, filled, or partially filled with any substance; (i) petroleum and petroleum products, including crude oil or any fraction thereof, natural gas, natural gas liquids, liquefied natural gas, or synthetic gas usable for fuel, or any such mixture; and (j) such other substances, materials, and wastes that are or become regulated under applicable local, state, or federal law, or that are classified as hazardous or toxic under any Governmental Requirements or that, even if not so regulated, are known to pose a hazard to the health and safety of the occupants of the Mortgaged Property or of real property adjacent to it.

[*If appropriate, add*]

Despite the foregoing, Hazardous Substance does not apply to materials commonly used in the construction, operation, and maintenance of _ _[*describe property, e.g., an office building development*]_ _, as long as such materials are properly used, transported, and disposed of.

[*Continue*]

1.10. "Impositions." All real estate and personal property taxes, water, gas, sewer, electricity, and other utility rates and charges; charges imposed under any subdivision, planned unit development, or condominium declaration or restrictions; charges for any easement, license, or agreement maintained for the benefit of the Mortgaged Property, and all other taxes, charges, and assessments and any interest, costs, or penalties of any kind and nature that at any time before or after the execution of this Deed of Trust may be assessed, levied, or imposed on the Mortgaged Property or on its ownership, use, occupancy, or enjoyment.

1.11. "Improvements." Any and all buildings, structures, improvements, fixtures, and appurtenances now and later placed on the Mortgaged Property, including, without limitation, all apparatus and equipment, whether or not physically affixed to the land or any building, which is used to provide or supply air cooling, air conditioning, heat, gas, water, light, power, refrigeration, ventilation, laundry, drying, dish washing, garbage disposal, or other services; and all elevators, escalators, and related machinery and equipment, fire prevention and extinguishing apparatus, security and access control apparatus, partitions, ducts, compressors, plumbing, ovens, refrigerators, dishwashers, disposals, washers, dryers, awnings, storm windows, storm doors, screens, blinds, shades, curtains, curtain rods, mirrors, cabinets, paneling, rugs, attached floor coverings, furniture, pictures, antennas, pools, spas, pool and spa operation and maintenance equipment and apparatus, and trees and plants located on the Mortgaged Property, all of which, including replacements and additions, shall conclusively be deemed to be affixed to and be part of the Mortgaged Property conveyed to Trustee under this Deed of Trust.

1.12. "Indebtedness." The principal of, interest on, and all other amounts and payments due under or evidenced by the following:

1.12.1. The Note (including, without limitation, the prepayment premium, late payment, and other charges payable under the Note);

1.12.2. This Deed of Trust and all other Loan Documents;

1.12.3. All funds later advanced by Lender to or for the benefit of Borrower under any provision of any of the Loan Documents;

1.12.4. Any future loans or amounts advanced by Lender to Borrower when evidenced by a written instrument or document that specifically recites that the Obligations evidenced by such document are secured by the terms of this Deed of Trust, including, but not limited to, funds advanced to protect the security or priority of the Deed of Trust; and

1.12.5. Any amendment, modification, extension, rearrangement, restatement, renewal, substitution, or

replacement of any of the foregoing.

[*If applicable, add*]

[*Option: Cross-collateralize separate loan*]

1.12.6. That certain promissory note dated _ _[*date*]_ _, in the amount of _ _[*dollar amount*]_ _ given by Borrower to Lender.

[*Continue*]

1.13. "Land." The real estate or any interest in it described in Exhibit A attached to this Deed of Trust and made a part of it, together with all Improvements and Fixtures and all rights, titles, and interests appurtenant to it.

1.14. "Leases." Any and all leases, subleases, licenses, concessions, or other agreements (written or verbal, now or later in effect) that grant a possessory interest in and to, or the right to extract, mine, reside in, sell, or use the Mortgaged Property, and all other agreements, including, but not limited to, utility contracts, maintenance agreements, and service contracts that in any way relate to the use, occupancy, operation, maintenance, enjoyment, or ownership of the Mortgaged Property, except any and all leases, subleases, or other agreements under which Borrower is granted a possessory interest in the Land.

1.15. "Legal Requirement(s)." Collectively, (a) any and all present and future judicial decisions, statutes, rulings, rules, regulations, permits, certificates, or ordinances of any Governmental Authority in any way applicable to Borrower, any guarantor (with respect to the Indebtedness or the Mortgaged Property), or the Mortgaged Property, including, but not limited to, those concerning its ownership, use, occupancy, possession, operation, maintenance, alteration, repair, or reconstruction, (b) Borrower's or guarantor's presently or subsequently effective bylaws and articles of incorporation, or any instruments establishing any partnership, limited partnership, joint venture, trust, limited liability company, or other form of business association (if either, both, or all, by any of same), (c) any and all Leases and other contracts (written or oral) of any nature to which Borrower or any guarantor may be bound, and (d) any and all restrictions, reservations, conditions, easements, or other covenants or agreements now or later of record affecting the Mortgaged Property.

1.16. "Lender." The named Lender in this Deed of Trust and the owner and holder (including a pledgee) of any Note, Indebtedness, or Obligations secured by this Deed of Trust, whether or not named as Lender in this Deed of Trust, and the heirs, legatees, devisees, administrators, executors, successors, and assigns of any such person.

1.17. "Loan." The extension of credit made by Lender to Borrower under the terms of the Loan Documents.

1.18. "Loan Documents." Collectively, this Deed of Trust, the Note, and all other instruments and agreements required to be executed by Borrower or any guarantor in connection with the Loan.

1.19. "Mortgaged Property." The Land, Improvements, Fixtures, Personalty, Leases, and Rents, together with:

1.19.1. All right, title, and interest (including any claim or demand or demand in law or equity) that Borrower now has or may later acquire in or to such Mortgaged Property; all easements, rights, privileges, tenements, hereditaments, and appurtenances belonging or in any way appertaining to the Mortgaged Property; all of the estate, right, title, interest, claim, demand, reversion, or remainder of Borrower in or to the Mortgaged Property, either at law or in equity, in possession or expectancy, now or later acquired; all crops growing or to be grown on the Mortgaged Property; all development rights or credits and air rights; all water and water rights (whether or not appurtenant to the Mortgaged Property) and shares of stock pertaining to such water or water rights, ownership of which affects the Mortgaged Property; all minerals, oil, gas, and other hydrocarbon substances and rights thereto in, on, under, or upon the Mortgaged Property and all royalties and profits from any such rights or shares of stock; all right, title, and interest of Borrower in and to any streets, ways, alleys, strips, or gores of land adjoining the Land or any part of it that Borrower now owns or at any time later acquires and all adjacent lands within enclosures or occupied by buildings partly situated on the Mortgaged Property;

1.19.2. All intangible Mortgaged Property and rights relating to the Mortgaged Property or its operation or used in connection with it, including, without limitation, permits, licenses, plans, specifications, construction

contracts, subcontracts, bids, deposits for utility services, installations, refunds due Borrower, trade names, trademarks, and service marks;

1.19.3. All of the right, title, and interest of Borrower in and to the land lying in the bed of any street, road, highway, or avenue in front of or adjoining the Land;

1.19.4. Any and all awards previously made or later to be made by any Governmental Authority to the present and all subsequent owners of the Mortgaged Property that may be made with respect to the Mortgaged Property as a result of the exercise of the right of eminent domain, the alteration of the grade of any street, or any other injury to or decrease of value of the Mortgaged Property, which award or awards are assigned to Lender and Lender, at its option, is authorized, directed, and empowered to collect and receive the proceeds of any such award or awards from the authorities making them and to give proper receipts and acquittances for them, and to apply them as provided in _ _[*paragraph* _ _]_ _;

1.19.5. All certificates of deposit of Borrower in Lender's possession and all bank accounts of Borrower with Lender and their proceeds, and all deposits of Borrower with any Governmental Authority and/or public utility company that relate to the ownership of the Mortgaged Property;

1.19.6. All Leases of the Mortgaged Property or any part of it now or later entered into and all right, title, and interest of Borrower under such Leases, including cash or securities deposited by the tenants to secure performance of their obligations under such Leases (whether such cash or securities are to be held until the expiration of the terms of such Leases or applied to one or more of the installments of rent coming due immediately before the expiration of such terms), all rights to all insurance proceeds and unearned insurance premiums arising from or relating to the Mortgaged Property, all other rights and easements of Borrower now or later existing pertaining to the use and enjoyment of the Mortgaged Property, and all right, title, and interest of Borrower in and to all declarations of covenants, conditions, and restrictions as may affect or otherwise relate to the Mortgaged Property;

1.19.7. Any and all proceeds of any insurance policies covering the Mortgaged Property, whether or not such insurance policies were required by Lender as a condition of making the loan secured by this Deed of Trust or are required to be maintained by Borrower as provided below in this Deed of Trust; which proceeds are assigned to Lender, and Lender, at its option, is authorized, directed, and empowered to collect and receive the proceeds of such insurance policies from the insurers issuing the same and to give proper receipts and acquittances for such policies, and to apply the same as provided below;

1.19.8. If the Mortgaged Property includes a leasehold estate, all of Borrower's right, title, and interest in and to the lease, more particularly described in Exhibit A attached to this Deed of Trust (the Leasehold) including, without limitation, the right to surrender, terminate, cancel, waive, change, supplement, grant subleases of, alter, or amend the Leasehold;

1.19.9. All plans and specifications for the Improvements; all contracts and subcontracts relating to the Improvements; all deposits (including tenants' security deposits; provided, however, that if Lender acquires possession or control of tenants' security deposits Lender shall use the tenants' security deposits only for such purposes as Governmental Requirements permit), funds, accounts, contract rights, instruments, documents, general intangibles, and notes or chattel paper arising from or in connection with the Land or other Mortgaged Property; all permits, licenses, certificates, and other rights and privileges obtained in connection with the Land or other Mortgaged Property; all soils reports, engineering reports, land planning maps, drawings, construction contracts, notes, drafts, documents, engineering and architectural drawings, letters of credit, bonds, surety bonds, any other intangible rights relating to the Land and Improvements, surveys, and other reports, exhibits, or plans used or to be used in connection with the construction, planning, operation, or maintenance of the Land and Improvements and all amendments and modifications; all proceeds arising from or by virtue of the sale, lease, grant of option, or other disposition of all or any part of the Land, Fixtures, Personalty, or other Mortgaged Property (consent to same is not granted or implied); and all proceeds (including premium refunds) payable or to be payable under each insurance policy relating to the Land, Fixtures, Personalty, or other Mortgaged Property;

1.19.10. All trade names, trademarks, symbols, service marks, and goodwill associated with the Mortgaged Property and any and all state and federal applications and registrations now or later used in connection with the use or operation of the Mortgaged Property;

1.19.11. All tax refunds, bills, notes, inventories, accounts and charges receivable, credits, claims, securities, and documents of all kinds, and all instruments, contract rights, general intangibles, bonds and deposits, and all proceeds and products of the Mortgaged Property;

1.19.12. All money or other personal property of Borrower (including, without limitation, any instrument, deposit account, general intangible, or chattel paper, as defined in Division 9 of the California Uniform Commercial Code) previously or later delivered to, deposited with, or that otherwise comes into Lender's possession;

1.19.13. All accounts, contract rights, chattel paper, documents, instruments, books, records, claims against third parties, money, securities, drafts, notes, proceeds, and other items relating to the Mortgaged Property;

1.19.14. All construction, supply, engineering, and architectural contracts executed and to be executed by Borrower for the construction of the Improvements; and

1.19.15. All proceeds of any of the foregoing.

As used in this Deed of Trust, "Mortgaged Property" is expressly defined as meaning all or, when the context permits or requires, any portion of it and all or, when the context permits or requires, any interest in it.

1.20. "Note." The Promissory Note payable by Borrower to the order of Lender in the principal amount of _ _[*dollar amount*]_ _ dollars ($_ _[*dollar amount*]_ _), evidencing the Loan, in such form as is acceptable to Lender, together with any and all rearrangements, extensions, renewals, substitutions, replacements, modifications, restatements, and amendments to the Promissory Note.

1.21. "Obligation(s)." Any and all of the covenants, warranties, representations, and other obligations (other than to repay the Indebtedness) made or undertaken by Borrower to Lender or Trustee as set forth in the Loan Documents; any lease, sublease, or other agreement under which Borrower is granted a possessory interest in the Land; each obligation, covenant, and agreement of Borrower in the Loan Documents or in any other document executed by Borrower in connection with the loan(s) secured by this Deed of Trust whether set forth in or incorporated into the Loan Documents by reference; each and every monetary provision of all covenants, conditions, and restrictions, if any, pertaining to the Mortgaged Property and on Lender's written request, the enforcement by Borrower of any covenant by third parties to pay maintenance or other charges, if they have not been paid, or valid legal steps taken to enforce such payment within _ _[*e.g., 90 days*]_ _ after such written request is made; if the Mortgaged Property consists of or includes a leasehold estate, each obligation, covenant, and agreement of Borrower arising under, or contained in, the instrument(s) creating any such leasehold; all agreements of Borrower to pay fees and charges to Lender whether or not set forth in this Deed of Trust; and charges, as allowed by law, when they are made for any statement regarding the obligations secured by this Deed of Trust.

[*If applicable, add*]

[*Option: Exclusion of third party guaranty*]

The Obligations specifically exclude the Environmental Indemnity Agreement dated _ _[*date*]_ _, executed by _ _[*name*]_ _, which is not secured by this Deed of Trust.

[*Continue*]

1.22. "Permitted Encumbrance(s)." At any particular time, (a) liens for taxes, assessments, or governmental charges not then due and payable or not then delinquent; (b) liens, easements, encumbrances, and restrictions on the Mortgaged Property that are allowed by Lender to appear in Schedule B, with Parts I and II of an ALTA title policy to be issued to Lender following recordation of the Deed of Trust; and (c) liens in favor of or consented to in writing by Lender.

1.23. "Person." Natural persons, corporations, partnerships, unincorporated associations, joint ventures, and any other form of legal entity.

1.24. "Personalty." All of the right, title, and interest of Borrower in and to all tangible and intangible personal property, whether now owned or later acquired by Borrower, including, but not limited to, water rights (to the extent they may constitute personal property), all equipment, inventory, goods, consumer goods,

accounts, chattel paper, instruments, money, general intangibles, letter-of-credit rights, deposit accounts, investment property, documents, minerals, crops, and timber (as those terms are defined in the California Uniform Commercial Code) and that are now or at any later time located on, attached to, installed, placed, used on, in connection with, or are required for such attachment, installation, placement, or use on the Land, the Improvements, Fixtures, or on other goods located on the Land or Improvements, together with all additions, accessions, accessories, amendments, modifications to the Land or Improvements, extensions, renewals, and enlargements and proceeds of the Land or Improvements, substitutions for, and income and profits from, the Land or Improvements. The Personalty includes, but is not limited to, all goods, machinery, tools, equipment (including fire sprinklers and alarm systems); building materials, air conditioning, heating, refrigerating, electronic monitoring, entertainment, recreational, maintenance, extermination of vermin or insects, dust removal, refuse and garbage equipment; vehicle maintenance and repair equipment; office furniture (including tables, chairs, planters, desks, sofas, shelves, lockers, and cabinets); safes, furnishings, appliances (including ice-making machines, refrigerators, fans, water heaters, and incinerators); rugs, carpets, other floor coverings, draperies, drapery rods and brackets, awnings, window shades, venetian blinds, curtains, other window coverings; lamps, chandeliers, other lighting fixtures; office maintenance and other supplies; loan commitments, financing arrangements, bonds, construction contracts, leases, tenants' security deposits, licenses, permits, sales contracts, option contracts, lease contracts, insurance policies, proceeds from policies, plans, specifications, surveys, books, records, funds, bank deposits; and all other intangible personal property. Personalty also includes any other portion or items of the Mortgaged Property that constitute personal property under the California Uniform Commercial Code.

1.25. "Rents." All rents, issues, revenues, income, proceeds, royalties, profits, license fees, prepaid municipal and utility fees, bonds, and other benefits to which Borrower or the record title owner of the Mortgaged Property may now or later be entitled from or which are derived from the Mortgaged Property, including, without limitation, sale proceeds of the Mortgaged Property; any room or space sales or rentals from the Mortgaged Property; and other benefits paid or payable for using, leasing, licensing, possessing, operating from or in, residing in, selling, mining, extracting, or otherwise enjoying or using the Mortgaged Property.

1.26. "Water Rights." All water rights of whatever kind or character, surface or underground, appropriative, decreed, or vested, that are appurtenant to the Mortgaged Property or otherwise used or useful in connection with the intended development of the Mortgaged Property.

[*If applicable, add*]

[*Option: Coordination with separate loan agreement*]

Any terms not otherwise defined in this Deed of Trust shall have the meaning given them in the Loan Agreement dated _ _[*date*]_ _, between Borrower and Lender.

Comment: The definition of "attorney fees" in paragraph 1.1 includes a provision for attorney fees incurred in bankruptcy proceedings and for prosecuting an action for waste. Under 11 USC §506(b), an award of attorney fees incurred in connection with a mortgagee's relief from stay motion is permissible if (a) the claim is an allowed secured claim, (b) the creditor is oversecured, (c) the fees are reasonable, and (d) the fees are provided for by agreement. *Kamai v Long Beach Mortgage Co.* (*In re Kamai)* (BAP 9th Cir 2004) 316 BR 544, 548. If the loan documents limit a lender's recourse to the extent that the borrower commits waste, without an express provision for recovery of attorney fees in prosecuting the waste action, the lender may only recover to the extent of the waste, because fees are generally not awarded in such actions and personal liability for attorney fees will not be implied. *Aozora Bank, Ltd. v 1333 North Cal. Blvd.* (2004) 119 CA4th 1291, 1296, 15 CR3d 340. Attorney fees awarded to a real property secured lender in a collateral action brought by the debtor after the foreclosure should not be characterized as part of the indebtedness satisfied at the foreclosure sale or as a prohibited deficiency judgment. The award of such attorney fees is not limited by CC §§2924c or 2924d (which provide limits on the amounts that a foreclosing lender can claim as expenses of foreclosing on real property). See *Jones v Union Bank* (2005) 127 CA4th 542, 25 CR3d 783.

Paragraph 1.12.6 should be added if the lender wishes to cross-collateralize (see §4.13) by having the deed of trust secure a different loan (other than the one defined as the "Note") to the same borrower.

If there is a separate, unsecured environmental indemnity agreement to avoid any ambiguity about whether the agreement is secured by the deed of trust, the definition of Obligations in paragraph 1.21 should specifically exclude the agreement. If there is a loan agreement, counsel should add that term to the definition and add the optional language at the end of this provision. On environmental indemnity agreements generally, see chap 5A; for a form

environmental indemnity agreement, see §5A.12.

For further discussion of definitions, see §§4.17-4.20.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.67 6. Form: Repair and Maintenance of Mortgaged Property

§4.67 6. Form: Repair and Maintenance of Mortgaged Property

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.

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4.67-1 Repair and maintenance of mortgaged property

2. Repair and Maintenance of Mortgaged Property. Borrower shall (a) keep the Mortgaged Property in good condition and repair; (b) not substantially alter, remove, or demolish the Mortgaged Property or any of the Improvements except when incident to the replacement of Fixtures, equipment, machinery, or appliances with items of like kind; (c) restore and repair to the equivalent of its original condition all or any part of the Mortgaged Property that may be damaged or destroyed, including, but not limited to, damage from termites and dry rot, soil subsidence, and construction defects, whether or not insurance proceeds are available to cover any part of the cost of such restoration and repair, and regardless of whether Lender permits the use of any insurance proceeds to be used for restoration under _ _[*e.g., paragraph 5*]_ _ of this Deed of Trust; (d) pay when due all claims for labor performed and materials furnished in connection with the Mortgaged Property and not permit any mechanics' or materialman's lien to arise against the Mortgaged Property or furnish a loss or liability bond against such mechanics' or materialman's lien claims; (e) comply with all laws affecting the Mortgaged Property or requiring that any alterations, repairs, replacements, or improvements be made on it; (f) not commit or permit waste on or to the Mortgaged Property, or commit, suffer, or permit any act or violation of law to occur on it; (g) not abandon the Mortgaged Property; (h) cultivate, irrigate, fertilize, fumigate, and prune in accordance with prudent agricultural practices; (i) if required by Lender, provide for management satisfactory to Lender under a management contract approved by Lender; (j) notify Lender in writing of any condition at or on the Mortgaged Property that may have a significant and measurable effect on its market value; (k) if the Mortgaged Property is rental property, generally operate and maintain it in such manner as to realize its maximum rental potential; and (*l*) do all other things that the character or use of the Mortgaged Property may reasonably render necessary to maintain it in the same condition (reasonable wear and tear expected) as existed at the date of this Deed of Trust.

Comment: On the repair and maintenance covenant, see §4.22.

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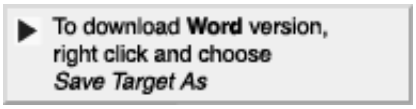
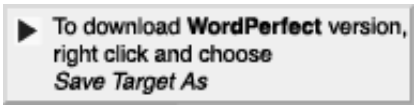
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.68 7. Form: Use of Mortgaged Property

§4.68 7. Form: Use of Mortgaged Property

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.





4.68-1 Use of mortgaged property

3. Use of Mortgaged Property. Unless otherwise required by Governmental Requirements or unless Lender otherwise consents in writing, Borrower shall not allow changes in the use of the Mortgaged Property from that which is contemplated by Borrower and Lender at the time of execution of this Deed of Trust, as specified in the loan application and the Loan Documents. Borrower shall not initiate or acquiesce in a change in the zoning classification of the Mortgaged Property without Lender's prior written consent.

Comment: On use of the mortgaged property, see §4.23.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.69 8. Form: Insurance

§4.69 8. Form: Insurance

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.

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4.69-1 Insurance

4. Insurance.

4.1. Casualty Insurance. Borrower shall at all times keep the Mortgaged Property insured for the benefit of Trustee and Lender as follows, despite Governmental Requirements that may detrimentally affect Borrower's ability to obtain or may materially increase the cost of such insurance coverage:

4.1.1. Against damage or loss by fire and such other hazards (including lightning, windstorm, hail, explosion, riot, acts of striking employees, civil commotion, vandalism, malicious mischief, aircraft, vehicle, and smoke) as are covered by the broadest form of extended coverage endorsement available from time to time, in an amount not less than the full insurable value (as defined in _ _[*e.g., paragraph 4.9*]_ _) of the Mortgaged Property, with a deductible amount not to exceed an amount satisfactory to Lender;

4.1.2. Rent loss or business interruption or use and occupancy insurance on such basis and in such amounts and with such deductibles as are satisfactory to Lender;

4.1.3. Against damage or loss by flood if the Land is located in an area identified by the Secretary of Housing and Urban Development or any successor or other appropriate authority (governmental or private) as an area having special flood hazards and in which flood insurance is available under the National Flood Insurance Act of 1968 or the Flood Disaster Protection Act of 1973, as amended, modified, supplemented, or replaced from time to time, on such basis and in such amounts as Lender may require;

4.1.4. Against damage or loss from (a) sprinkler system leakage and (b) boilers, boiler tanks, heating and air conditioning equipment, pressure vessels, auxiliary piping, and similar apparatus, on such basis and in such amounts as Lender may require;

4.1.5. During any alteration, construction, or replacement of the Improvements, or any substantial portion of it, a Builder's All Risk policy with extended coverage with course of construction and completed value endorsements, for an amount at least equal to the full insurable value of the Improvements, and workers' compensation, in statutory amounts, with provision for replacement with the coverage described in _ _[*e.g., paragraph 4.1*]_ _, without gaps or lapsed coverage, for any completed portion of the Improvements; and

[*Add one of the following alternatives*]

[*Alternative 1: Earthquake insurance required in Lender's business judgment*]

4.1.6. Against damage or loss by earthquake, in an amount and with a deductible satisfactory to Lender, if such insurance is required by Lender in the exercise of its business judgment in light of the commercial real estate practices existing at the time the insurance is issued and in the County where the Land is located.

[*Alternative 2: Earthquake insurance customarily required*]

4.1.6. Against damage or loss by earthquake, in an amount and with a deductible satisfactory to Lender, if and to the extent such insurance is then customarily required by other institutional lenders holding security interests in property comparable to, and in the general vicinity of, the Land.

[*Add one of the following alternatives*]

[*Alternative 1: Terrorism insurance required if available at*

commercially reasonable rates]

4.1.7. Against damage or loss from perils of terrorism and acts of terrorism as long as such insurance coverage is available at commercially reasonable rates.

[*Alternative 2: Terrorism insurance customarily required*]

4.1.7. Against damage or loss from perils of terrorism and acts of terrorism, if and to the extent such insurance is then customarily required by other institutional lenders holding security interests in property comparable to, and in the general vicinity of, the Land.

[*Continue*]

4.2. Liability Insurance. Borrower shall procure and maintain workers' compensation insurance for Borrower's employees and comprehensive general liability insurance covering Borrower, Trustee, and Lender against claims for bodily injury or death or for damage occurring in, on, about, or resulting from the Mortgaged Property, or any street, drive, sidewalk, curb, or passageway adjacent to it, in standard form and with such insurance company or companies and in an amount of at least _ _[*dollar amount, e.g., $5,000,000*]_ _ combined single limit, or such greater amount as Lender may require, which insurance shall include completed operations, product liability, and blanket contractual liability coverage that insures contractual liability under the indemnifications set forth in this Deed of Trust and the Loan Documents (but such coverage or its amount shall in no way limit such indemnification).

4.3. Other Insurance. Borrower shall procure and maintain such other insurance or such additional amounts of insurance, covering Borrower or the Mortgaged Property, as (a) may be required by the terms of any construction contract for the Improvements or by any Governmental Authority, (b) may be specified in any other Loan Documents, or (c) may be _ _[*reasonably*]_ _ required by Lender from time to time.

4.4. Form of Policies. All insurance required under this _ _[*e.g., paragraph 4*]_ _ shall be fully paid for and nonassessable. The policies shall contain such provisions, endorsements, and expiration dates as Lender from time to time reasonably requests and shall be in such form and amounts, and be issued by such insurance companies doing business in the State of California, as Lender shall approve in Lender's sole and absolute discretion. Unless otherwise expressly approved in writing by Lender, each insurer shall have a Best Rating of Class A, Category VIII, or better. All policies shall (a) contain a waiver of subrogation endorsement; (b) provide that the policy will not lapse or be canceled, amended, or materially altered (including by reduction in the scope or limits of coverage) without at least _ _[*e.g., 30 days*]_ _ prior written notice to Lender; (c) with the exception of the comprehensive general liability policy, contain a mortgagee's endorsement (438 BFU Endorsement or equivalent), and name Lender and Trustee as insureds; and (d) include such deductibles as Lender may approve. If a policy required under this paragraph contains a co-insurance or overage clause, the policy shall include a stipulated value or agreed amount endorsement acceptable to Lender.

4.5. Duplicate Originals or Certificates. Duplicate original policies evidencing the insurance required under this _ _[*e.g., paragraph 4*]_ _ and any additional insurance that may be purchased on the Mortgaged Property by or on behalf of Borrower shall be deposited with and held by Lender and, in addition, Borrower shall deliver to Lender (a) receipts evidencing payment of all premiums on the policies and (b) duplicate original renewal policies or a binder with evidence satisfactory to Lender of payment of all premiums at least _ _[*e.g., 30 days*]_ _ before the policy expires. In lieu of the duplicate original policies to be delivered to Lender under this _ _[*e.g., paragraph 4.5*]_ _ Borrower may deliver an underlier of any blanket policy, and Borrower may also deliver original certificates from the issuing insurance company, evidencing that such policies are in full force and effect and containing information that, in Lender's reasonable judgment, is sufficient to allow Lender to ascertain whether such policies comply with the requirements of this paragraph.

4.6. Increased Coverage. If Lender determines that the limits of any insurance carried by Borrower are inadequate or that additional coverage is required, Borrower shall, within _ _[*e.g., 10 days*]_ _ after written notice from Lender, procure such additional coverage as Lender may require in Lender's sole and absolute discretion.

4.7. No Separate Insurance. Borrower shall not carry separate or additional insurance concurrent in form or contributing in the event of loss with that required under this _ _[*e.g., paragraph 4*]_ _ unless endorsed in favor of Trustee and Lender as required by this paragraph and otherwise approved by Lender in all respects.

4.8. Transfer of Title. In the event of foreclosure of this Deed of Trust or other transfer of title or assignment

of the Mortgaged Property in extinguishment, in whole or in part, of the Obligations and the Indebtedness, all right, title, and interest of Borrower in and to all insurance policies required under this _ _[*e.g., paragraph 4*]_ _ or otherwise then in force with respect to the Mortgaged Property and all proceeds payable under, and unearned premiums on, such policies shall immediately vest in the purchaser or other transferee of the Mortgaged Property.

4.9. Replacement Cost. For purposes of this _ _[*e.g., paragraph 4*]_ _ the term "full insurable value" means the actual cost of replacing the Mortgaged Property in question, without allowance for depreciation, as calculated from time to time (but not more often than once every calendar year) by the insurance company or companies holding such insurance or, at Lender's request, by appraisal made by an appraiser, engineer, architect, or contractor proposed by Borrower and approved by said insurance company or companies and Lender. Borrower shall pay the cost of such appraisal.

4.10. Approval Not Warranty. No approval by Lender of any insurer may be construed to be a representation, certification, or warranty of its solvency and no approval by Lender as to the amount, type, or form of any insurance may be construed to be a representation, certification, or warranty of its sufficiency.

4.11. Lender's Right to Obtain. Borrower shall deliver to Lender original policies or certificates evidencing such insurance at least _ _[*e.g., 30 days*]_ _ before the existing policies expire. If any such policy is not so delivered to Lender or if any such policy is canceled, whether or not Lender has the policy in its possession, and no reinstatement or replacement policy is received before termination of insurance, Lender, without notice to or demand on Borrower, may (but is not obligated to) obtain such insurance insuring only Lender and Trustee with such company as Lender may deem satisfactory, and pay the premium for such policies, and the amount of any premium so paid shall be charged to and promptly paid by Borrower or, at Lender's option, may be added to the Indebtedness. Borrower acknowledges that, if Lender obtains insurance, it is for the sole benefit of Lender and Trustee, and Borrower shall not rely on any insurance obtained by Lender to protect Borrower in any way.

4.12. Duty to Restore After Casualty. If any act or occurrence of any kind or nature (including any casualty for which insurance was not obtained or obtainable) results in damage to or loss or destruction of the Mortgaged Property, Borrower shall immediately give notice of such loss or damage to Lender and, if Lender so instructs, shall promptly, at Borrower's sole cost and expense, regardless of whether any insurance proceeds will be sufficient for the purpose, commence and continue diligently to completion to restore, repair, replace, and rebuild the Mortgaged Property as nearly as possible to its value, condition, and character immediately before the damage, loss, or destruction.

Comment: As drafted in this form, the lender is *not* required to be reasonable in exercising its discretion as to satisfactory amounts and types of insurance. The borrower should try to negotiate a reasonableness standard (see suggested addition of reasonableness standard in form paragraph 4.3), but should not expect much flexibility because insurance requirements are generally a matter of the lender's internal policies concerning insurance coverage. For further discussion of the lender's discretion, see §4.10. On insurance requirements generally, see §4.26.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.70 9. Form: Condemnation and Insurance Proceeds

§4.70 9. Form: Condemnation and Insurance Proceeds

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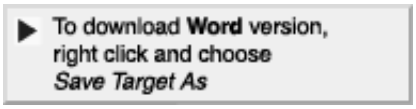

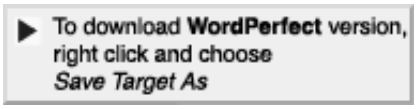

4.70-1 Condemnation and insurance proceeds

5. Condemnation and Insurance Proceeds.

5.1. Assignment to Lender. The proceeds of any award or claim for damages, direct or consequential, in connection with any condemnation or other taking of or damage or injury to the Mortgaged Property, or any part of it, or for conveyance in lieu of condemnation, are assigned to and shall be paid to Lender, who shall hold them in a _ _[*non-interest-bearing general account/general account bearing interest at a rate paid on like accounts by Lender*]**_ _, regardless of whether Lender's security is impaired. All causes of action, whether accrued before or after the date of this Deed of Trust, of all types for damages or injury to the Mortgaged Property or any part of it, or in connection with any transaction financed by funds lent to Borrower by Lender and secured by this Deed of Trust, or in connection with or affecting the Mortgaged Property or any part of it, including, without limitation, causes of action arising in tort or contract or in equity, are assigned to Lender as additional security, and the proceeds shall be paid to Lender. _ _**[*If, in Lender's reasonable judgment, Borrower is not diligently pursuing collection of such proceeds or taking other actions to adequately protect the Mortgaged Property, then*]**_ _ Lender, at its option, may appear in and prosecute in its own name any action or proceeding to enforce any such cause of action and may make any compromise or settlement of such action. Borrower shall notify Lender in writing immediately on obtaining knowledge of any casualty damage to the Mortgaged Property or damage in any other manner in excess of _ _**[*dollar amount, e.g., $5000*]**_ _ or knowledge of the institution of any proceeding relating to condemnation or other taking of or damage or injury to all or any portion of the Mortgaged Property. Lender, in its sole and absolute discretion, may participate in any such proceedings and may join Borrower in adjusting any loss covered by insurance. Borrower covenants and agrees with Lender, at Lender's request, to make, execute, and deliver, at Borrower's expense, any and all assignments and other instruments sufficient for the purpose of assigning the aforesaid award or awards, causes of action, or claims of damages or proceeds to Lender free, clear, and discharged of any and all encumbrances of any kind or nature;**

[*Borrower will want to add the following option*]

[*Option: Automatic release*]

Despite the foregoing, if such proceeds do not exceed _ _[*dollar amount, e.g., $5000*]**_ _ during any calendar year, Borrower may retain such funds.**

[*Continue*]

5.2. Insurance Payments. All compensation, awards, proceeds, damages, claims, insurance recoveries, rights of action, and payments that Borrower may receive or to which Lender may become entitled with respect to the Mortgaged Property if any damage or injury occurs to the Mortgaged Property, other than by a partial condemnation or other partial taking of the Mortgaged Property, shall be paid over to Lender and shall be applied first toward reimbursement of all costs and expenses of Lender in connection with their recovery and disbursement, and shall then be applied as follows:

5.2.1. Lender shall consent to the application of such payments to the restoration of the Mortgaged Property so damaged only if Borrower has met all the following conditions (a breach of one of which shall constitute a default under this Deed of Trust, the Note, and any Loan Documents): (a) Borrower is not in default under any of the terms, covenants, and conditions of the Loan Documents; (b) all then-existing Leases affected in any way by such damage will continue in full force and effect; (c) Lender is satisfied that the insurance or award proceeds, plus any sums added by Borrower, shall be sufficient to fully restore and rebuild the Mortgaged Property under then current Governmental Requirements; (d) within _ _[*e.g., 60 days*]**_ _ after the damage to**

the Mortgaged Property, Borrower presents to Lender a restoration plan satisfactory to Lender and any local planning department, which includes cost estimates and schedules; (e) construction and completion of restoration and rebuilding of the Mortgaged Property shall be completed in accordance with plans and specifications and drawings submitted to Lender within _ _[*e.g., 30 days*]_ _ after receipt by Lender of the restoration plan and thereafter approved by Lender, which plans, specifications, and drawings shall not be substantially modified, changed, or revised without Lender's prior written consent; (f) within _ _[*e.g., 3 months*]_ _ after such damage, Borrower and a licensed contractor satisfactory to Lender enter into a fixed price or guaranteed maximum price contract satisfactory to Lender, providing for complete restoration in accordance with such restoration plan for an amount not to exceed the amount of funds held or to be held by Lender; (g) all restoration of the Improvements so damaged or destroyed shall be made with reasonable promptness and shall be of a value at least equal to the value of the Improvements so damaged or destroyed before such damage or destruction; (h) Lender reasonably determines that there is an identified source (whether from income from the Mortgaged Property, rental loss insurance, or another source) sufficient to pay all debt service and operating expenses of the Mortgaged Property during its restoration as required above; and (i) any and all funds that are made available for restoration and rebuilding under this _ _[*e.g., paragraph 5*]_ _ shall be disbursed, at Lender's sole and absolute discretion to Lender, through Lender, the Trustee, or a title insurance or trust company satisfactory to Lender, in accordance with standard construction lending practices, including a reasonable fee payable to Lender from such funds and, if Lender requests, mechanics' lien waivers and title insurance date-downs, and the provision of payment and performance bonds by Borrower, or in any other manner approved by Lender in Lender's sole and absolute discretion; or

5.2.2. If fewer than all conditions (a) through (i) in _ _[*e.g., paragraph 5.2.1*]_ _ are satisfied, then such payments shall be applied in the sole and absolute discretion of Lender (a) to the payment or prepayment, with any applicable prepayment premium, of any Indebtedness secured by this Deed of Trust in such order as Lender may determine, or (b) to the reimbursement of Borrower's expenses incurred in the rebuilding and restoration of the Mortgaged Property. If Lender elects under this _ _[*e.g., paragraph 5.2.2*]_ _ to make any funds available to restore the Mortgaged Property, then all of conditions (a) through (i) in _ _[*e.g., paragraph 5.2.1*]_ _ shall apply, except for such conditions that Lender, in its sole and absolute discretion, may waive.

5.3. Material Loss Not Covered. If any material part of the Mortgaged Property is damaged or destroyed and the loss, measured by the replacement cost of the Improvements according to then current Governmental Requirements, is not adequately covered by insurance proceeds collected or in the process of collection, Borrower shall deposit with Lender, within _ _[*e.g., 30 days*]_ _ after Lender's request, the amount of the loss not so covered.

5.4. Total Condemnation Payments. All compensation, awards, proceeds, damages, claims, insurance recoveries, rights of action, and payments that Borrower may receive or to which Borrower may become entitled with respect to the Mortgaged Property in the event of a total condemnation or other total taking of the Mortgaged Property shall be paid over to Lender and shall be applied first to reimbursement of all Lender's costs and expenses in connection with their recovery, and shall then be applied to the payment of any Indebtedness secured by this Deed of Trust in such order as Lender may determine, until the Indebtedness secured by this Deed of Trust has been paid and satisfied in full. Any surplus remaining after payment and satisfaction of the Indebtedness secured by this Deed of Trust shall be paid to Borrower as its interest may then appear.

5.5. Partial Condemnation Payments. All compensation, awards, proceeds, damages, claims, insurance recoveries, rights of action, and payments ("funds") that Borrower may receive or to which Borrower may become entitled with respect to the Mortgaged Property in the event of a partial condemnation or other partial taking of the Mortgaged Property, unless Borrower and Lender otherwise agree in writing, shall be divided into two portions, one equal to

[*Add one of the following three alternatives*]

[*Alternative 1: Lender shares in award to extent of loan-to-value ratio immediately before recordation of deed of trust*]

the total of the funds multiplied by the percentage the original principal balance of the Note bore to the fair market value of the Mortgaged Property immediately before the date the Deed of Trust was recorded and the other equal to the difference between such percentage and 100 percent.

[*Alternative 2: Lender shares in award to extent of outstanding principal balance of note*]

the principal balance of the Note at the time of receipt of such funds and the other equal to the amount by

which such funds exceed the principal balance of the Note at the time of receipt of such funds.

[*Alternative 3: Lender shares in award to extent of loan-to-value ratio immediately before the taking*]

the total of the funds multiplied by the percentage of the principal balance of the Note immediately before the date of the partial taking bore to the fair market value of the Mortgaged Property immediately before the date of the partial taking and the other equal to the difference between such percentage and 100 percent.

[*Continue*]

The first such portion shall be applied to the sums secured by this Deed of Trust, whether or not then due, including but not limited to principal, accrued interest, and advances, and in such order or combination as Lender may determine, with the balance of the funds paid to Borrower. Any dispute as to the fair market value of the Mortgaged Property shall be settled by arbitration in accordance with the Real Estate Valuation Arbitration Rules of the American Arbitration Association.

5.6. No Cure of Waiver of Default. Any application of such amounts or any portion of it to any Indebtedness secured by this Deed of Trust shall not be construed to cure or waive any default or notice of default under this Deed of Trust or invalidate any act done under any such default or notice.

Comment: On application of condemnation awards, see §§4.27-4.28. On negotiating a reasonableness standard for the exercise of the lender's discretion, see §4.10.

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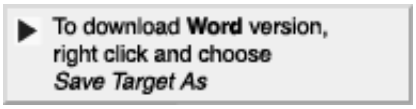
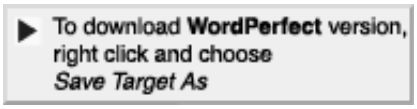
§4.71 10. Form: Taxes and Other Sums Due

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.





4.71-1 Taxes and other sums due

6. Taxes and Other Sums Due. Borrower shall promptly pay, satisfy, and discharge: (a) all Impositions affecting the Mortgaged Property before they become delinquent; (b) such other amounts, chargeable against Borrower or the Mortgaged Property, as Lender reasonably deems necessary to protect and preserve the Mortgaged Property, this Deed of Trust, or Lender's security for the performance of the Obligations; (c) all encumbrances, charges, and liens on the Mortgaged Property, with interest, which in Lender's judgment are, or appear to be, prior or superior to the lien of this Deed of Trust or all costs necessary to obtain protection against such lien or charge by title insurance endorsement or surety company bond; (d) such other charges as Lender deems reasonable for services rendered by Lender at Borrower's request; and (e) all costs, fees, and expenses incurred by Lender in connection with this Deed of Trust, whether or not specified in this Deed of Trust.

On Lender's request, Borrower shall promptly furnish Lender with all notices of sums due for any amounts specified in the preceding _ _[*e.g., clauses 6(a) through (e)*]_ _, and, on payment, with written evidence of such payment. If Borrower fails to promptly make any payment required under this _ _[*e.g., paragraph 6*]_ _ Lender may (but is not obligated to) make such payment. Borrower shall notify Lender immediately on receipt by Borrower of notice of any increase in the assessed value of the Mortgaged Property and agrees that Lender, in Borrower's name, may (but is not obligated to) contest by appropriate proceedings such increase in assessment. Without Lender's prior written consent, Borrower shall not allow any lien inferior to the lien of this Deed of Trust to be perfected against the Mortgaged Property and shall not permit any improvement bond for any unpaid special assessment to issue.

Comment: On payment of taxes and other expenses, see §4.29.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.72 11. Form: Leases of Mortgaged Property by Borrower

§4.72 11. Form: Leases of Mortgaged Property by Borrower

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4.72-1 Leases of mortgaged property by borrower

7. Leases of Mortgaged Property by Borrower. At Lender's request, Borrower shall furnish Lender with executed copies of all Leases of the Mortgaged Property or any portion of it then in force. All Leases later entered into by Borrower _ _[*with a term of at least _ _[number]_ _ years or with leased premises of at least _ _[number]_ _ square feet*]_ _ are subject to Lender's prior review and approval and must be acceptable to Lender in form and content. Each Lease must specifically provide, inter alia, that (a) it is subordinate to the lien of this Deed of Trust; (b) the tenant attorns to Lender (and Borrower consents to any such attornment), such attornment to be effective on Lender's acquisition of title to the Mortgaged Property; (c) the tenant agrees to execute such further evidence of attornment as Lender may from time to time request; (d) the tenant's attornment shall not be terminated by foreclosure; and (e) Lender, at Lender's option, may accept or reject such attornment. If Borrower learns that any tenant proposes to do, or is doing, any act that may give rise to any right of setoff against rent, Borrower shall immediately (i) take measures reasonably calculated to prevent the accrual of any such right of setoff; (ii) notify Lender of all measures so taken and of the amount of any setoff claimed by any such tenant; and (iii) within _ _[*e.g., 10 days*]_ _ after the accrual of any right of setoff against rent, reimburse any tenant who has acquired such right, in full, or take other measures that will effectively discharge such setoff and ensure that rents subsequently due shall continue to be payable without claim of setoff or deduction.

At Lender's request, Borrower shall assign to Lender, by written instrument satisfactory to Lender, all Leases of the Mortgaged Property, and all security deposits made by tenants in connection with such Leases. On assignment to Lender of any such Lease, Lender shall succeed to all rights and powers of Borrower with respect to such Lease, and Lender, in Lender's sole and absolute discretion, shall have the right to modify, extend, or terminate such Lease and to execute other further leases with respect to the Mortgaged Property that is the subject of such assigned Lease.

Comment: On leases of mortgaged property, see §§4.30-4.32. On negotiating a reasonableness standard for exercise of the lender's discretion, see §4.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.73 12. Form: Borrower's Right to Collect and Receive Rents

§4.73 12. Form: Borrower's Right to Collect and Receive Rents

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4.73-1 Borrower's right to collect and receive rents

8. Right to Collect and Receive Rents. Despite any other provision of this Deed of Trust, Lender grants permission to Borrower to collect and retain the Rents of the Mortgaged Property as they become due and payable; however, such permission to Borrower shall be automatically revoked on default by Borrower in payment of any Indebtedness secured by this Deed of Trust or in the performance of any of the Obligations, and Lender shall have the rights set forth in California Civil Code §2938 regardless of whether declaration of default has been delivered to Trustee as provided in _ _[*e.g., paragraph 21*]_ _ of this Deed of Trust, and without regard to the adequacy of the security for the Indebtedness secured by this Deed of Trust. Failure of or discontinuance by Lender at any time, or from time to time, to collect any such Rents shall not in any manner affect the subsequent enforcement by Lender at any time, or from time to time, of the right, power, and authority to collect these Rents. The receipt and application by Lender of all such Rents under this Deed of Trust, after execution and delivery of declaration of default and demand for sale as provided in this Deed of Trust or during the pendency of trustee's sale proceedings under this Deed of Trust, shall neither cure such breach or default nor affect such sale proceedings, or any sale made under them, but such Rents, less all costs of operation, maintenance, collection, and Attorney Fees, when received by Lender, may be applied in reduction of the entire Indebtedness from time to time secured by this Deed of Trust, in such order as Lender may decide. Nothing in this Deed of Trust, nor the exercise of Lender's right to collect, nor an assumption by Lender of any tenancy, lease, or option, nor an assumption of liability under, nor a subordination of the lien or charge of this Deed of Trust to, any such tenancy, lease, or option, shall be, or be construed to be, an affirmation by Lender of any tenancy, lease, or option.

If the Rents of the Mortgaged Property are not sufficient to meet the costs, if any, of taking control of and managing the Mortgaged Property and collecting the Rents, any funds expended by Lender for such purposes shall become Indebtedness of Borrower to Lender secured by this Deed of Trust. Unless Lender and Borrower agree in writing to other terms of payment, such amounts shall be payable on notice from Lender to Borrower requesting such payment and shall bear interest from the date of disbursement at the rate stated in the Note unless payment of interest at such rate would be contrary to Governmental Requirements, in which event the amounts shall bear interest at the highest rate that may be collected from Borrower under Governmental Requirements.

Borrower expressly understands and agrees that Lender will have no liability to Borrower or any other person for Lender's failure or inability to collect Rents from the Mortgaged Property or for failing to collect such Rents in an amount that is equal to the fair market rental value of the Mortgaged Property. Borrower understands and agrees that neither the assignment of Rents to Lender nor the exercise by Lender of any of its rights or remedies under this Deed of Trust shall be deemed to make Lender a "mortgagee-in-possession" or otherwise responsible or liable in any manner with respect to the Mortgaged Property or the use, occupancy, enjoyment, or operation of all or any portion of it, unless and until Lender, in person or by agent, assumes actual possession of it. Nor shall appointment of a receiver for the Mortgaged Property by any court at the request of Lender or by agreement with Borrower, or the entering into possession of the Mortgaged Property or any part of it by such receiver be deemed to make Lender a mortgagee-in-possession or otherwise responsible or liable in any manner with respect to the Mortgaged Property or the use, occupancy, enjoyment, or operation of all or any portion of it.

During an Event of Default, any and all Rents collected or received by Borrower shall be accepted and held for Lender in trust and shall not be commingled with Borrower's funds and property, but shall be promptly paid over to Lender.

Comment: On the right to collect rents, see §4.33. On negotiating a reasonableness standard for exercise of the lender's discretion, see §4.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.74 13. Form: Funds for Taxes and Insurance

§4.74 13. Form: Funds for Taxes and Insurance

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4.74-1 Funds for taxes and insurance

9. Funds for Taxes and Insurance. If Borrower is in default under this Deed of Trust or any of the Loan Documents, regardless of whether the default has been cured, then Lender may at any subsequent time, at its option to be exercised on _ _[*e.g., 30 days*]_ _ written notice to Borrower, require Borrower to deposit with Lender or its designee, at the time of each payment of an installment of interest or principal under the Note, an additional amount sufficient to discharge the obligations of Borrower under _ _[*e.g., paragraphs 4 and 6*]_ _ of this Deed of Trust as they become due. The calculation of the amount payable and of the fractional part of it to be deposited with Lender shall be made by Lender in its sole and absolute discretion. These amounts shall be held by Lender or its designee not in trust and not as agent of Borrower and shall not bear interest, and shall be applied to the payment of any of the Obligations under the Loan Documents in such order or priority as Lender shall determine. If at any time within _ _[*e.g., 30 days*]_ _ before the due date of these obligations the amounts then on deposit shall be insufficient to pay the obligations under _ _[*e.g., paragraphs 4 and 6*]_ _ in full, Borrower shall deposit the amount of the deficiency with Lender within _ _[*e.g., 10 days*]_ _ after Lender's demand. If the amounts deposited are in excess of the actual obligations for which they were deposited, Lender may refund any such excess, or, at its option, may hold the excess in a reserve account, not in trust and not bearing interest, and reduce proportionately the required monthly deposits for the ensuing year. Nothing in this paragraph shall be deemed to affect any right or remedy of Lender under any other provision of this Deed of Trust or under any statute or rule of law to pay any such amount and to add the amount so paid to the Indebtedness secured by this Deed of Trust. Lender shall have no obligation to pay insurance premiums or taxes except to the extent the fund established under this paragraph is sufficient to pay such premiums or taxes, to obtain insurance, or to notify Borrower of any matters relative to the insurance or taxes for which the fund is established under this paragraph.

Lender or its designee shall hold all amounts so deposited as additional security for the sums secured by this Deed of Trust. Lender may, in its sole and absolute discretion and without regard to the adequacy of its security under this Deed of Trust, apply such amounts or any portion of it to any Indebtedness secured by this Deed of Trust, and such application shall not be construed to cure or waive any default or notice of default under this Deed of Trust.

If Lender requires deposits to be made under this _ _[*e.g., paragraph 9*]_ _, Borrower shall deliver to Lender all tax bills, bond and assessment statements, statements for insurance premiums, and statements for any other obligations referred to above as soon as Borrower receives such documents.

[*Borrower will want to add the following option*]

[*Option: Discontinuance of impound account*]

If Borrower has timely cured all defaults under this Deed of Trust or under any of the Loan Documents and no further defaults have occurred for one year after the first payment required by this _ _[*e.g., paragraph 9*]_ _, Borrower may cease making the payments required by this paragraph and payments shall be required thereafter only if a subsequent default occurs.

[*Continue*]

If Lender sells or assigns this Deed of Trust, Lender shall have the right to transfer all amounts deposited under this _ _[*e.g., paragraph 9*]_ _ to the purchaser or assignee. After such a transfer, Lender shall be relieved and have no further liability under this Deed of Trust for the application of such deposits, and Borrower shall look solely to such purchaser or assignee for such application and for all responsibility relating to such deposits.

Comment: On tax and insurance impounds, see §4.34. On negotiating a reasonableness standard for exercise of the lender's discretion, see §4.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.75 14. Form: Assignment of Causes of Action, Awards, and Damages

§4.75 14. Form: Assignment of Causes of Action, Awards, and Damages

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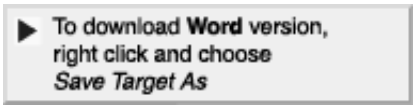

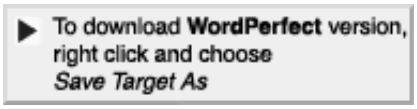

4.75-1 Assignment of causes of action, awards, and damages

10. <u>Assignment of Causes of Action, Awards, and Damages</u>. All causes of action, and all sums due or payable to Borrower for injury or damage to the Mortgaged Property, or as damages incurred in connection with the transactions in which the Loan secured by this Deed of Trust was made, including, without limitation, causes of action and damages for breach of contract, fraud, concealment, construction defects, or other torts, or compensation for any conveyance in lieu of condemnation, are assigned to Lender, and all proceeds from such causes of action and all such sums shall be paid to Lender for credit against the Indebtedness secured by this Deed of Trust. Borrower shall notify Lender immediately on receipt by Borrower of notice that any such sums have become due or payable and, immediately on receipt of any such sums, shall promptly remit such sums to Lender.

After deducting all expenses, including Attorney Fees, incurred by Lender in recovering or collecting any sums under this _ _[*e.g., paragraph 10*]_ _, Lender may apply or release the balance of any funds received by it under this paragraph, or any part of such balance, as it elects. Lender, at its option, may appear in and prosecute in its own name any action or proceeding to enforce any cause of action assigned to it under this paragraph and may make any compromise or settlement in such action whatsoever. Borrower covenants that it shall execute and deliver to Lender such further assignments of any such compensation awards, damages, or causes of action as Lender may request from time to time. If Lender fails or does not elect to prosecute any such action or proceeding and Borrower elects to do so, Borrower may conduct the action or proceeding at its own expense and risk.

Comment: On assignment of borrower's claims against third parties, and negotiating an "impairment of security" standard for the lender's discretion in this area, see §4.35.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.76 15. Form: Defense of Deed of Trust; Litigation

§4.76 15. Form: Defense of Deed of Trust; Litigation

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4.76-1 Defense of deed of trust; litigation

11. <u>Defense of Deed of Trust; Litigation</u>. Borrower shall give Lender immediate written notice of any action or proceeding (including, without limitation, any judicial, whether civil, criminal, or probate, or nonjudicial proceeding to foreclose the lien of a junior or senior mortgage or deed of trust) affecting or purporting to affect the Mortgaged Property, this Deed of Trust, Lender's security for the performance of the Obligations and payment of the Indebtedness, or the rights or powers of Lender or Trustee under the Loan Documents. Despite any other provision of this Deed of Trust, Borrower agrees that

[*Borrower will want to add the following option*]

[*Option: Borrower fails to protect mortgaged property*]

, if Lender or Trustee reasonably believes that Borrower is not taking adequate steps to protect the Mortgaged Property,

[*Continue*]

Lender or Trustee may (but is not obligated to) commence, appear in, prosecute, defend, compromise, and settle, in Lender's or Borrower's name, and as attorney-in-fact for Borrower, and incur necessary costs and expenses, including Attorney Fees in so doing, any action or proceeding, whether a civil, criminal, or probate judicial matter, nonjudicial proceeding, arbitration, or other alternative dispute resolution procedure, reasonably necessary to preserve or protect, or affecting or purporting to affect, the Mortgaged Property, this Deed of Trust, Lender's security for performance of the Obligations and payment of the Indebtedness, or the rights or powers of Lender or Trustee under the Loan Documents, and that if neither Lender nor Trustee elects to do so, Borrower shall commence, appear in, prosecute, and defend any such action or proceeding. Borrower shall pay all costs and expenses of Lender and Trustee, including costs of evidence of title and Attorney Fees, in any such action or proceeding in which Lender or Trustee may appear or for which legal counsel is sought, whether by virtue of being made a party defendant or otherwise, and whether or not the interest of Lender or Trustee in the Mortgaged Property is directly questioned in such action or proceeding, including, without limitation, any action for the condemnation or partition of all or any portion of the Mortgaged Property and any action brought by Lender to foreclose this Deed of Trust or to enforce any of its terms or provisions.

Comment: On the lender's right to protect its security interests in litigation, see §4.36. On the lender's reciprocal right to attorney fees, see §4.38.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.77 16. Form: Lender's Rights on Borrower's Default

§4.77 16. Form: Lender's Rights on Borrower's Default

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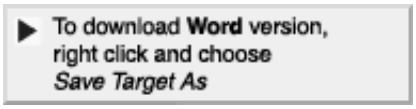

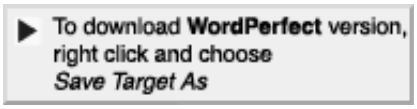

4.77-1 Lender's rights on borrower's default

12. Borrower's Failure to Comply With Deed of Trust. If Borrower fails to make any payment or do any act required by this Deed of Trust, or if there is any action or proceeding (including, without limitation, any judicial or nonjudicial proceeding to foreclose the lien of a junior or senior mortgage or deed of trust) affecting or purporting to affect the Mortgaged Property, this Deed of Trust, Lender's security for the performance of the Obligations and payment of the Indebtedness, or the rights or powers of Lender or Trustee under the Note or this Deed of Trust, Lender or Trustee may (but is not obligated to) (a) make any such payment or do any such act in such manner and to such extent as either deems necessary to preserve or protect the Mortgaged Property, this Deed of Trust, or Lender's security for the performance of Borrower's Obligations and payment of the Indebtedness, or the rights or powers of Lender or Trustee under the Loan Documents, Lender and Trustee being authorized to enter on the Mortgaged Property for any such purpose; and (b) in exercising any such power, pay necessary expenses, retain attorneys, and pay Attorney Fees incurred in connection with such action, without notice to or demand on Borrower and without releasing Borrower from any Obligations or Indebtedness.

Comment: On steps the lender may take to protect its security interest, see §4.36. On attorney fees, see §4.38. On negotiating a reasonableness standard for exercise of the lender's discretion, see §4.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.78 17. Form: Sums Advanced

§4.78 17. Form: Sums Advanced

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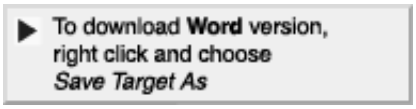

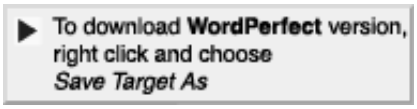

4.78-1 Sums advanced

13. Sums Advanced to Bear Interest and to Be Secured by Deed of Trust. At Lender's request, Borrower shall immediately pay any sums advanced or paid by Lender or Trustee under any provision of this Deed of Trust or the other Loan Documents. Until so repaid, all such sums and all other sums payable to Lender or Trustee shall be added to, and become a part of, the Indebtedness secured by this Deed of Trust and bear interest from the date of advancement or payment by Lender or Trustee at the same rate as provided in the Note, unless payment of interest at such rate would be contrary to Governmental Requirements. All sums advanced by Lender under this Deed of Trust or the other Loan Documents, whether or not required to be advanced by Lender under the terms of this Deed of Trust or the other Loan Documents, shall conclusively be deemed to be mandatory advances required to preserve and protect this Deed of Trust and Lender's security for the performance of the Obligations and payment of the Indebtedness, and shall be secured by this Deed of Trust to the same extent and with the same priority as the principal and interest payable under the Note.

Comment: On reimbursement of the lender's expenses, see §4.37. On attorney fees, see §4.38. On future advances, see §4.52.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.79 18. Form: Inspection

§4.79 18. Form: Inspection

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4.79-1 Inspection

14. <u>Inspection of Mortgaged Property</u>. In addition to any rights Lender may have under California Civil Code §2929.5, Lender may make, or authorize other persons, including, but not limited to, appraisers and prospective purchasers at any foreclosure sale commenced by Lender, to enter on or inspect the Mortgaged Property at reasonable times and for reasonable durations. Borrower shall permit all such entries and inspections to be made as long as Lender has given Borrower written notice of such inspection at least _ _[*e.g., 24 hours*]**_ _ before the entry and inspection.**

Comment: The borrower should require that the lender, in its inspections, not interfere with the tenants' quiet enjoyment of their premises.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.80 19. Form: Financial Statements; Estoppel Certificates

§4.80 19. Form: Financial Statements; Estoppel Certificates

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4.80-1 Financial statements; estoppel certificates

15. Financial Statements; Estoppel Certificates.

15.1. Borrower's Financial Statements. On receipt of Lender's written request and without expense to Lender, Borrower shall furnish to Lender (a) an annual statement of the operation of the Mortgaged Property prepared and certified by Borrower, showing in reasonable detail satisfactory to Lender total Rents received and total expenses together with an annual balance sheet and profit and loss statement, within _ _[*e.g., 120 days*]_ _ after the close of each fiscal year of Borrower, beginning with the fiscal year first ending after the date of recordation of this Deed of Trust; (b) within _ _[*e.g., 30 days*]_ _ after the end of each calendar quarter (March 31, June 30, September 30, December 31) interim statements of the operation of the Mortgaged Property showing in reasonable detail satisfactory to Lender total Rents and other income and receipts received and total expenses for the previous quarter, certified by Borrower; and (c) copies of Borrower's annual state and federal income tax returns within _ _[*e.g., 30 days*]_ _ after filing them. Borrower shall keep accurate books and records, and allow Lender, its representatives and agents, on notice, at any time during normal business hours, access to such books and records regarding acquisition, construction, and development of the Mortgaged Property, including any supporting or related vouchers or papers, shall allow Lender to make extracts or copies of any such papers, and shall furnish to Lender and its agents convenient facilities for the audit of any such statements, books, and records.

[*Add if borrower may limit cost of audit*]

Borrower agrees to pay Lender for audits in an amount no greater than _ _[*e.g., $500*]_ _ per annum.

[*Continue*]

15.2. Recordkeeping. Borrower shall keep adequate records and books of account in accordance with generally accepted accounting principles and practices and shall permit Lender, by its agents, accountants, and attorneys, to examine Borrower's records and books of account and to discuss the affairs, finances, and accounts of Borrower with the officers of Borrower, at such reasonable times as Lender may request.

15.3. Guarantors' Financial Statements. Except to the extent already required by _ _[*e.g., paragraph 15.1*]_ _, Borrower, its controlling shareholders, and all guarantors of the Indebtedness, if any, shall deliver to Lender with reasonable promptness after the close of their respective fiscal years a balance sheet and profit and loss statement, prepared by an independent certified public accountant satisfactory to Lender, setting forth in each case, in comparative form, figures for the preceding year, which statements shall be accompanied by the unqualified opinion of such accountant as to their accuracy. Throughout the term of this Deed of Trust, Borrower and any guarantor shall deliver, with reasonable promptness, to Lender such other information with respect to Borrower or guarantor as Lender may from time to time request. All financial statements of Borrower or guarantor shall be prepared in accordance with generally accepted accounting principles and practices applied on a consistent basis and shall be delivered in duplicate.

[*Borrower will want to add the following option*]

[*Option: Confidentiality*]

Documents and information submitted by Borrower to Lender are submitted confidentially, and Lender shall not disclose them to third parties and shall limit access to them to what is necessary to service the loan, accomplish the normal administrative, accounting, tax-reporting, and other necessary functions, to sell all or any part of the loan and to report such information as required to the Comptroller of the Currency, the Federal

Deposit Insurance Corporation, the Internal Revenue Service, and similar entities.

[*Continue*]

15.4. Estoppel Certificates. Within _ _[*e.g., 10 days*]_ _ after Lender's request for such information, Borrower shall execute and deliver to Lender, and to any third party designated by Lender, in recordable form, a certificate of the principal financial or accounting officer of Borrower, dated within _ _[*e.g., 3 days*]_ _ after delivery of such statements, or the date of such request, as the case may be, reciting that the Loan Documents are unmodified and in full force and effect, or that the Loan Documents are in full force and effect as modified and specifying all modifications asserted by Borrower. Such certificate shall also recite the amount of the Indebtedness and cover other matters with respect to the Indebtedness or Obligations as Lender may reasonably require, the date(s) through which payments due on the Indebtedness have been paid and the amount(s) of any payments previously made on the Indebtedness. The certificate shall include a detailed statement of any right of setoff, counterclaim, or other defense that Borrower contends exists against the Indebtedness or the Obligations; a statement that such person knows of no Event of Default or prospective Event of Default that has occurred and is continuing, or, if any Event of Default or prospective Event of Default has occurred and is continuing, a statement specifying the nature and period of its existence and what action Borrower has taken or proposes to take with respect to such matter; and, except as otherwise specified, a statement that Borrower has fulfilled all Obligations that are required to be fulfilled on or before the date of such certificate.

15.5. Failure to Deliver Estoppel Certificate. If Borrower fails to execute and deliver the certificate required by _ _[*e.g., paragraph 15.4*]_ _ within such _ _[*e.g., 10-day*]_ _ period, (a) the Loan Documents shall, as to Borrower, conclusively be deemed to be either in full force and effect, without modification, or in full force and effect, modified in the manner and to the extent specified by Lender, whichever Lender reasonably and in good faith may represent; (b) the Indebtedness shall, as to Borrower, conclusively be deemed to be in the amount specified by Lender and no setoffs, counterclaims, or other defenses exist against the Indebtedness; and (c) Borrower shall conclusively be deemed to have irrevocably constituted and appointed Lender as Borrower's special attorney-in-fact to execute and deliver such certificate to any third party.

15.6. Reliance on Estoppel Certificate. Borrower and Lender expressly agree that any certificate executed and delivered by Borrower, or any representation in lieu of a certificate made by Lender under _ _[*e.g., paragraph 15.5*]_ _, may be relied on by any prospective purchaser or any prospective assignee of any interest of Lender in the Note and other Indebtedness secured by this Deed of Trust or in the Mortgaged Property, and by any other person, without independent investigation or examination, to verify the accuracy, reasonableness, or good faith of the recitals in the certificate or representation.

15.7. No Waiver of Default or Rights. Lender's exercise of any right or remedy provided by this _ _[*e.g., paragraph 15*]_ _ shall not constitute a waiver of, or operate to cure, any default by Borrower under this Deed of Trust, or preclude any other right or remedy that is otherwise available to Lender under this Deed of Trust or Governmental Requirements.

Comment: On financial statements and estoppel certificates, see §4.39.

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B. Uniform Commercial Code

§4.81 1. Form: Security Agreement

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4.81-1 Security agreement

16. Uniform Commercial Code Security Agreement. This Deed of Trust is intended to be and shall constitute a security agreement under the California Uniform Commercial Code for any of the Personalty specified as part of the Mortgaged Property that, under Governmental Requirements, may be subject to a security interest under the California Uniform Commercial Code, and Borrower grants to Lender a security interest in those items. Borrower authorizes Lender to file financing statements in all states, counties, and other jurisdictions as Lender may elect, without Borrower's signature if permitted by law. Borrower agrees that Lender may file this Deed of Trust, or a copy of it, in the real estate records or other appropriate index or in the Office of the Secretary of State of the State of California and such other states as the Lender may elect, as a financing statement for any of the items specified above as part of the Mortgaged Property. Any reproduction of this Deed of Trust or executed duplicate original of this Deed of Trust, or a copy certified by a County Recorder in the State of California, or of any other security agreement or financing statement, shall be sufficient as a financing statement. In addition, Borrower agrees to execute and deliver to Lender, at Lender's request, any UCC financing statements, as well as any extensions, renewals, and amendments, and copies of this Deed of Trust in such form as Lender may require to perfect a security interest with respect to the Personalty. Borrower shall pay all costs of filing such financing statements and any extensions, renewals, amendments, and releases of such statements, and shall pay all reasonable costs and expenses of any record searches for financing statements that Lender may reasonably require. Without the prior written consent of Lender, Borrower shall not create or suffer to be created any other security interest in the items, including any replacements and additions.

On any Event of Default, Lender shall have the remedies of a secured party under the California Uniform Commercial Code and, at Lender's option, may also invoke the remedies in _ _[*e.g., paragraph 21*]_ _ of this Deed of Trust as to such items. In exercising any of these remedies, Lender may proceed against the items of Mortgaged Property and any items of Personalty separately or together and in any order whatsoever, without in any way affecting the availability of Lender's remedies under the California Uniform Commercial Code or of the remedies in _ _[*e.g., paragraph 21*]_ _ of this Deed of Trust.

Comment: The lender legitimately wants all personal property necessary to step into the borrower's shoes as the owner/landlord or builder/developer of the project; this means tying up all janitorial supplies, leasing brochures, and rental contracts. The borrower, especially one conducting any business on the premises other than managing real property (*e.g.,* building and selling homes or conducting a retail business) wants to be sure that computers, vehicles, and other business assets unconnected with the real estate are not included in the lender's security interest. Borrowers should be wary of a lender's form that grants a security interest in "all existing and future tangible property, inventory, fittings, goods, model furnishings and other decorations, supplies, and materials now or hereafter owned by Borrower and located at or used in connection with the Property (whether or not such items are stored on the premises or elsewhere)," because such language arguably extends to any office equipment or vehicles used in the borrower's business.

For further discussion of limiting the lender's right to foreclose on personal property, see §4.40. On personal property security agreements generally, see chap 7. On filing financing statements without the borrower's signature, see §7.9. If the security agreement is not part of the deed of trust but personalty also secures repayment of the loan, the form security agreement in §§7.46-7.51 may be used.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.82 2. Form: Financing Statement

§4.82 2. Form: Financing Statement

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4.82-1 Financing statement

17. Fixture Filing. This Deed of Trust constitutes a financing statement filed as a fixture filing under California Commercial Code §9502(c), as amended or recodified from time to time, covering any portion of the Mortgaged Property that now is or later may become a fixture attached to the Mortgaged Property or to any Improvement.

Comment: On fixture filings, see §§4.40, 7.38-7.41.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.83 C. Form: Waiver of Statute of Limitations

§4.83 C. Form: Waiver of Statute of Limitations

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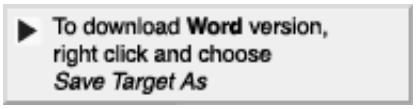

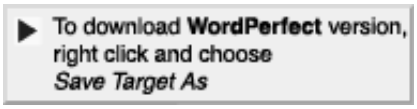

4.83-1 Waiver of statute of limitations

18. Waiver of Statute of Limitations. Borrower waives the right to assert any statute of limitations as a defense to the Loan Documents and the Obligations secured by this Deed of Trust, to the fullest extent permitted by Governmental Requirements.

Comment: On waiver of the statute of limitations, see §4.41.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.84 D. Form: Events of Default

§4.84 D. Form: Events of Default

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4.84-1 Events of default

19. Events of Default. The term Event of Default as used in this Deed of Trust means the occurrence or happening, at any time and from time to time, of any one or more of the following:

19.1. Payment of Indebtedness. Borrower fails to pay any installment of interest and/or principal under the Note or any other Indebtedness when due and such failure continues for more than _ _[*e.g., 10*]_ _ days after the date such payment was due and payable whether on maturity, the date stipulated in any Loan Document, by acceleration, or otherwise.

19.2. Performance of Obligations. The failure, refusal, or neglect to perform and discharge fully and timely any of the Obligations as and when required, and the continuance of such failure for _ _[*e.g., 90*]_ _ days after Lender gives written notice of such failure to Borrower.

19.3. Judgment. If any final judgment, order, or decree is rendered against Borrower or a guarantor and is not paid or executed on, or is not stayed by perfection of an appeal or other appropriate action, such as being bonded, or is not otherwise satisfied or disposed of to Lender's satisfaction within _ _[*e.g., 30*]_ _ days after entry of the judgment, order, or decree.

19.4. Voluntary Bankruptcy. If Borrower or any guarantor (a) seeks entry of an order for relief as a debtor in a proceeding under the Bankruptcy Code; (b) seeks, consents to, or does not contest the appointment of a receiver or trustee for itself or for all or any part of its property; (c) files a petition seeking relief under the bankruptcy, arrangement, reorganization, or other debtor relief laws of the United States or any state or any other competent jurisdiction; (d) makes a general assignment for the benefit of its creditors; or (e) states in writing its inability to pay its debts as they mature.

19.5. Involuntary Bankruptcy. If (a) a petition is filed against Borrower or any guarantor seeking relief under any bankruptcy, arrangement, reorganization, or other debtor relief laws of the United States or any state or other competent jurisdiction; or (b) a court of competent jurisdiction enters an order, judgment, or decree appointing, without the consent of Borrower or any guarantor, a receiver or trustee for it, or for all or any part of its property; and (c) such petition, order, judgment, or decree is not discharged or stayed within _ _[*e.g., 90*]_ _ days after its entry.

19.6. Foreclosure of Other Liens. If the holder of any lien or security interest on the Mortgaged Property (without implying Lender's consent to the existence, placing, creating, or permitting of any lien or security interest) institutes foreclosure or other proceedings to enforce its remedies thereunder and any such proceedings are not stayed or discharged within _ _[*e.g., 60*]_ _ days after institution of such foreclosure proceedings.

19.7. Sale, Lease, Encumbrance, or Other Transfer. Any sale, lease, exchange, assignment, conveyance, encumbrance (other than a Permitted Encumbrance), transfer of possession, or other disposition of all or any portion of the Land or Improvements or any of Borrower's interest in the Land or Improvement without Lender's prior written consent, or any sale, lease, exchange, assignment, conveyance, encumbrance (other than a Permitted Encumbrance), or other disposition of any portion of the Personalty, without Lender's prior written consent.

19.8. Title and Lien Priority. If Borrower's title to any or all of the Mortgaged Property or the status of this Deed of Trust as a first and prior lien and security interest on the Mortgaged Property is endangered in any

manner, and Borrower fails to cure the same on Lender's demand; provided, however, that Borrower shall not be in default under this paragraph if Borrower is diligently pursuing a contest or cure of such title or lien issue and Borrower has posted adequate security to protect Lender's rights, interest, and priority under this Deed of Trust, as determined by Lender.

19.9. Other Defaults. The occurrence of an Event of Default or any default, as defined or described in the other Loan Documents, or the occurrence of a default on any Indebtedness or Obligations.

19.10. Levy on Assets. A levy on any of the assets of Borrower or any guarantor, and such levy is not stayed or abated within _ _[*e.g., 60*]_ _ days after such levy.

19.11. Breach of Representations. The breach of any representation, warranty, or covenant in this Deed of Trust or other Loan Documents.

19.12. Default Under Prior Deed of Trust, Security Instrument, or Lien. The failure to pay on a timely basis, or the occurrence of any other default under any note, deed of trust, contract of sale, lien, charge, encumbrance, or security interest encumbering or affecting the Mortgaged Property and having priority over the lien of this Deed of Trust.

[*If cure periods are short, borrower should try to obtain the following optional language*]

[*Option: General cure provision*]

19.13. Borrower's Right to Cure. If for more than _ _[*e.g., 30 days*]_ _ after receipt of notice from Lender, Borrower remains in default under any term, covenant, or condition of this Deed of Trust, the Note or any of the other Loan Documents other than as specified in paragraph _ _[*list monetary default sections, e.g., 19.1.1*]_ _; provided, however, that if the cure of any such default cannot reasonably be made within _ _[*e.g., 30 days*]_ _ and Borrower promptly and diligently commences to cure such default within _ _[*e.g., 30 days*]_ _, then the period to cure shall be deemed extended for up to an additional _ _[*e.g., 60 days*]_ _ after Lender's default notice as long as Borrower diligently and continuously proceeds to cure such default to Lender's satisfaction.

Comment: Paragraphs 19.2, 19.3, 19.5, 19.6, and 19.10 all contain time periods within which a borrower must act or be in default under the deed of trust. Lenders want a short period to force the borrower to act promptly. If the borrower does act promptly, the lender will usually let the borrower continue with the matter until it is accomplished. Nevertheless, the borrower should try to negotiate a longer period of time. The periods of time in these five paragraphs reflect the borrower's desire for longer time frames. Lenders prefer shorter periods—perhaps only 10 days—within which the borrower must act. In such cases, the borrower may try to obtain a general right to cure for all nonmonetary defaults. See optional language in paragraph 19.13.

On events of default and cure periods, see §4.42. On acceleration on sale or encumbrance of the property, see §§4.43-4.44. On the borrower's bankruptcy as an event of default, and acceleration on other defaults, see §4.45. On negotiating a reasonableness standard for the exercise of the lender's discretion, see §4.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/ E. Acceleration/§4.85 1. Form: Transfer or Encumbrance

E. Acceleration

§4.85 1. Form: Transfer or Encumbrance

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4.85-1 Transfer or encumbrance

20. Acceleration on Transfer or Encumbrance.

20.1. Acceleration on Transfer or Encumbrance of Mortgaged Property. If Borrower sells, contracts to sell, gives an option to purchase, conveys, leases with an option to purchase, encumbers, or alienates the Mortgaged Property, or any interest in it, or suffers its title to, or any interest in, the Mortgaged Property to be divested, whether voluntarily or involuntarily; or if there is a sale or transfer of beneficial interests in Borrower equal to _ _[*e.g., 25 percent*]_ _ or more of the beneficial ownership interests of Borrower outstanding at the date of this Deed of Trust; or if Borrower changes or permits to be changed the character or use of the Mortgaged Property, or drills or extracts or enters into any lease for the drilling or extracting of oil, gas, or other hydrocarbon substances or any mineral of any kind or character on the Mortgaged Property; or if title to such Mortgaged Property becomes subject to any lien or charge, voluntary or involuntary, contractual or statutory, without Lender's prior written consent, then Lender, at Lender's option, may, without prior notice, declare all sums secured by this Deed of Trust, regardless of their stated due date(s), immediately due and payable and may exercise all rights and remedies in this Deed of Trust, including those in _ _[*e.g., paragraph 21*]_ _.

20.2. Replacement Personalty. Despite the provisions of _ _[*e.g., paragraph 20.1*]_ _, Borrower may from time to time replace Personalty constituting a part of the Mortgaged Property, as long as (a) the replacements for such Personalty are of equivalent value and quality; (b) Borrower has good and clear title to such replacement Personalty free and clear of any and all liens, encumbrances, security interests, ownership interests, claims of title (contingent or otherwise), or charges of any kind, or the rights of any conditional sellers, vendors, or any other third parties in or to such replacement Personalty have been expressly subordinated to the lien of the Deed of Trust in a manner satisfactory to Lender and at no cost to Lender; and (c) at Lender's option, Borrower provides at no cost to Lender satisfactory evidence that the Deed of Trust constitutes a valid and subsisting lien on and security interest in such replacement Personalty of the same priority as this Deed of Trust has on the Mortgaged Property and is not subject to being subordinated or its priority affected under any Governmental Requirements, including §9334 of the California Commercial Code.

[*If applicable, add one or more of the following options*]

[*Option 1:Transfer permitted to limited liability company*]

20.3. Transfer to Limited Liability Company. As long as Borrower gives Lender at least _ _[*e.g., 30 days*']_ _ written notice of the proposed transfer and agrees to reimburse Lender for all out-of-pocket costs and expenses incurred in connection with such transfer and if Lender consents in writing, which consent may not be unreasonably withheld, the due-on-sale provision set forth in _ _[*e.g., paragraph 20.1*]_ _ shall not apply to a one-time transfer of the Mortgaged Property from Borrower to a limited liability company or other similar single-purpose entity created by Borrower that is domiciled in the United States and is wholly owned by Borrower and Borrower agrees it shall remain liable on the Loan.

[*Option 2: Single transfer permitted if specified conditions met*]

20.3. Permitted Assumptions. Despite the provisions of _ _[*e.g., paragraph 20.1*]_ _, Lender shall not exercise its right to require immediate payment in full of all sums secured by this Deed of Trust on transfer of all or part of the Mortgaged Property, provided that the Mortgaged Property and Borrower's successor in interest qualify for assumption under Lender's then current appraisal and underwriting standards, and further provided that

Borrower's successor in interest agrees in writing to all terms required by Lender and the conditions and obligations set forth in this Deed of Trust, and payment of Lender's standard assumption fee, and further provided that the Note is not in default at the time of the sale or transfer and has not been delinquent more than once in any calendar year. In no event, however, shall Lender consent to more than one transfer of the Property secured by this Deed of Trust. Beneficiary's consent to any such transfer shall not relieve Borrower of liability to repay the Note that this Deed of Trust secures.

[*If applicable, add the following option*]

[*Option: Borrower has limited right to have new owner assume loan*]

20.4. Assumption of Loan. Despite the provisions of _ _[*e.g., paragraph 20.1*]_ _, Lender shall not exercise its right to require immediate payment in full of all sums secured by this Deed of Trust on transfer of all or part of the Mortgaged Property, provided that the Mortgaged Property and Borrower's successor in interest qualify for assumption according to Lender's then current appraisal and underwriting standards, and further provided that Borrower's successor in interest agrees in writing to all of the terms required by Lender and the conditions and obligations set forth in this Deed of Trust, and pays Lender's standard assumption fee, and further provided that the Note is not in default at the time of the sale or transfer and has not been delinquent more than once in any calendar year. Lender's consent to any such transfer shall not relieve Borrower of liability to repay the Note that this Deed of Trust secures.

[*If applicable, add the following option*]

[*Option: Additional encumbrances are permitted if debt service ratio is met*]

20.5. Permitted Encumbrances. If Lender consents in writing, which consent may not be unreasonably withheld, the due-on-encumbrance provision set forth in _ _[*e.g., paragraph 20.1*]_ _ shall not apply to a junior voluntary deed of trust or mortgage lien in favor of another lender encumbering the Mortgaged Property (the principal balance of any such junior encumbrance shall be added to the principal balance of the Indebtedness for purposes of determining compliance with the financial covenants of the Note); as long as Borrower gives Lender at least _ _[*e.g., 30 days*']_ _ written notice of the further encumbrance and reimburses Lender for all out-of-pocket costs and expenses incurred in connection with such encumbrance.

Comment: On due-on-transfer provisions and assumption of loans, see §§4.43-4.44. On negotiating a reasonableness standard for the exercise of the lender's discretion, see §4.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.86 2. Form: Acceleration and Sale on Default

§4.86 2. Form: Acceleration and Sale on Default

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4.86-1 Acceleration and sale on default

21. Acceleration and Sale on Default. If an Event of Default occurs, Lender, at its option, in addition to other remedies provided at law, may declare all sums secured by this Deed of Trust immediately due and payable by delivering to Trustee a written affidavit or declaration of default and demand for sale, executed by Lender and reciting facts demonstrating such default by Borrower, together with a written notice of default and election to sell the Mortgaged Property. Lender shall also deposit with Trustee the Note, this Deed of Trust, and documents evidencing any additional advances or expenditures secured by this Deed of Trust. On receipt by Trustee of such affidavit or declaration of default and such notice of default and election to sell, Trustee shall accept such election to sell as true and conclusive of all facts and statements in such affidavit or declaration of default and shall cause such notice of default and election to sell to be recorded as required by Governmental Requirements. On the expiration of such period as may then be required by Governmental Requirements following recordation of such notice of default, and after notice of sale has been given in the manner and for the period required by Governmental Requirement, Trustee, without demand on Borrower, shall sell the Mortgaged Property at the time and place fixed in such notice of sale, either in whole or in separate parcels, and in such order as Trustee may determine or Lender may direct (Borrower waives any right it may have under Governmental Requirements to direct the order of sale), at public auction to the highest bidder for cash in lawful money of the United States, payable at the time of sale; provided, however, that Lender may offset its bid at such sale to the extent of the full amount owed to Lender under the Loan Documents, including, without limitation, Trustee's fees, expenses of sale, and costs, expenses, and Attorney Fees incurred by or on behalf of Lender in connection with collecting, litigating, or otherwise enforcing any right under the Loan Documents. Trustee may postpone the sale of all or any portion of the Mortgaged Property by public announcement made at the initial time and place of sale, and from time to time later by public announcement made at the time and place of sale fixed by the preceding postponement. Trustee shall deliver to the purchaser at such public auction its deed conveying the Mortgaged Property sold, but without any covenant or warranty, express or implied. The recital in such deed of any matter of fact concerning notices shall be conclusive proof of its truthfulness. Any person, including Borrower, Trustee, or Lender, may purchase at such sale.

The proceeds or avails of any sale made under or by virtue of this Deed of Trust, together with any other sums secured by this Deed of Trust, which then may be held by the Trustee or Lender or any other person, shall be applied as follows:

FIRST: To the payment of the costs and expenses of such sale, including Trustee's fees, costs of title evidence, Attorney Fees, and reasonable compensation to Lender and its agents and consultants, and of any judicial proceedings in which the same costs and expenses of sale may be made, and of all expenses, liabilities, and advances made or incurred by the Trustee or Lender under this Deed of Trust, together with interest at the rate set forth in the Note on all advances made by the Trustee or Lender and all taxes or assessments, except any taxes, assessments, or other charges subject to which the Mortgaged Property was sold.

SECOND: To the payment of the whole amount then due, owing, or unpaid on the Note for interest and principal, with interest on the unpaid principal at the Default Rate (as defined in the Note), from the due date of any such payment of principal until the same is paid.

THIRD: To the payment of any other Indebtedness required to be paid by Borrower under any provision of this Deed of Trust, the Note, or any of the other Loan Documents.

FOURTH: To the payment of the surplus, if any, to whomsoever may be lawfully entitled to receive it.

Comment: On acceleration on default, see §4.45.

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§4.87 F. Form: Notification Obligation

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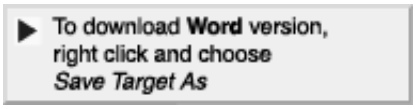

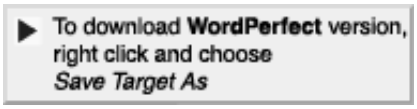

4.87-1 Notification obligation

22. <u>Obligation to Notify Lender of Bankruptcy, Insolvency, Transfer, or Encumbrance</u>. Borrower shall notify Lender in writing, at or before the time of the occurrence of any event described in _ _[*e.g., paragraphs 19 and 20*]**_ _ of this Deed of Trust, of such event and shall promptly furnish Lender with any and all information on such event that Lender may request.**

Comment: On events of default, see §4.42. On sale, transfer, or encumbrance of the mortgaged property, see §§4.43-4.44.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.88 G. Form: Waiver of Marshaling

§4.88 G. Form: Waiver of Marshaling

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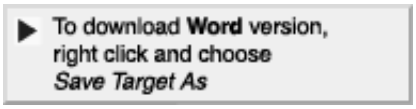

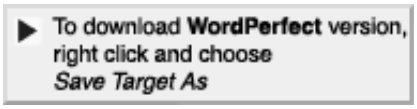

4.88-1 Waiver of marshaling

23. Waiver of Marshaling. Despite the existence of interests in the Mortgaged Property other than that created by this Deed of Trust, and despite any other provision of this Deed of Trust, if Borrower defaults in paying the Indebtedness or in performing any Obligations, Lender shall have the right, in Lender's sole and absolute discretion, to establish the order in which the Mortgaged Property will be subjected to the remedies provided in this Deed of Trust and to establish the order in which all or any part of the Indebtedness secured by this Deed of Trust is satisfied from the proceeds realized on the exercise of the remedies provided in this Deed of Trust. Borrower and any person who now has or later acquires any interest in the Mortgaged Property with actual or constructive notice of this Deed of Trust waives any and all rights to require a marshaling of assets in connection with the exercise of any of the remedies provided in this Deed of Trust or otherwise provided by Governmental Requirements.

Comment: On marshaling, see §4.46. On negotiating a standard of reasonableness for the exercise of the lender's discretion, see §4.10.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.89 H. Form: Environmental Matters

§4.89 H. Form: Environmental Matters

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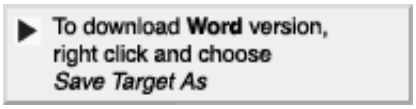

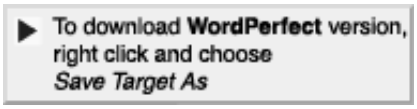

4.89-1 Environmental matters

24. Environmental Matters.

24.1. Borrower's Representations and Warranties. Borrower represents and warrants to Lender that:

24.1.1. The Mortgaged Property and Borrower are not in violation of any Environmental Laws or subject to any existing, pending, or threatened investigation by any Governmental Authority under any Environmental Laws.

24.1.2. Borrower has not obtained and is not required by any Environmental Laws to obtain any permits or licenses to construct or use the Mortgaged Property or the Improvements.

24.1.3. Borrower has conducted an appropriate inquiry into previous uses and ownership of the Mortgaged Property, and after such inquiry determined that no Hazardous Substance has been disposed of, transported, or released on or at the Mortgaged Property.

24.1.4. No part of the Mortgaged Property is being used or, to the knowledge of Borrower, has been used at any previous time, for the disposal, storage, treatment, processing, transporting, or other handling of Hazardous Substances, nor is any part of the Mortgaged Property affected by any Hazardous Substance contamination.

24.1.5. To the best of Borrower's knowledge and belief, no real property adjoining the Mortgaged Property is being used, or has ever been used at any previous time, for the disposal, storage, treatment, processing, or other handling of Hazardous Substances, nor is any other real property adjoining the Mortgaged Property affected by Hazardous Substances contamination.

24.1.6. No investigation, administrative order, consent order or agreement, litigation, or settlement with respect to Hazardous Substances or Hazardous Substances contamination is proposed, threatened, anticipated, or in existence regarding the Mortgaged Property. The Mortgaged Property is not currently on, and to Borrower's knowledge, after diligent investigation and inquiry, has never been on, any federal or state "Superfund" or "Superlien" list.

24.1.7. Neither Borrower nor, to the best of Borrower's knowledge and belief, any tenant of any portion of the Mortgaged Property has received any notice from any Governmental Authority regarding any violation of any Environmental Laws.

24.1.8. The use that Borrower makes and intends to make of the Mortgaged Property shall not result in the disposal or release of any Hazardous Substances on, in, or to the Mortgaged Property.

24.1.9. Borrower shall not cause any violation of any Environmental Laws, nor permit any tenant of any portion of the Mortgaged Property to cause such a violation, nor permit any environmental liens to be placed on any portion of the Mortgaged Property.

24.1.10. Neither Borrower nor any third party shall use, generate, manufacture, store, release, discharge, or dispose of any Hazardous Substance on, under, or about the Mortgaged Property, or transport any Hazardous Substance to or from the Mortgaged Property.

24.2. Survival of Representations and Warranties. The foregoing representations and warranties shall be continuing and shall be true and correct for the period from the date of this instrument to the release of this Deed of Trust (whether by payment of the Indebtedness secured by this Deed of Trust or foreclosure or action in lieu of foreclosure), and these representations and warranties shall survive such release.

24.3. Notice to Lender. Borrower shall give prompt written notice to Lender of:

24.3.1. Any proceeding or inquiry by any Governmental Authority (including, without limitation, the California State Department of Health Services) regarding the presence or threatened presence of any Hazardous Substance on the Mortgaged Property;

24.3.2. All claims made or threatened by any third party against Borrower or the Mortgaged Property relating to any loss or injury resulting from any Hazardous Substance;

24.3.3. Any notice given to Borrower under California Civil Code §851(b); and

24.3.4. Borrower's discovery of any occurrence or condition on any real property adjoining or in the vicinity of the Mortgaged Property that could cause it or any part of it to be subject to any restrictions on the ownership, occupancy, transferability, or use of the Mortgaged Property under any Environmental Laws.

24.4. Lender's Right to Join Legal Actions. Lender shall have the right, at its option, but at Borrower's sole cost and expense, to join and participate in, as a party if it so elects, any legal proceedings or actions initiated by or against Borrower or the Mortgaged Property in connection with any Environmental Laws.

24.5. Borrower's Indemnity. Borrower shall indemnify, defend, and hold harmless Lender, its directors, officers, employees, agents, successors, and assigns from and against any loss, damage, cost, expense, or liability directly or indirectly arising from or attributable to the use, generation, manufacture, production, storage, release, threatened release, discharge, disposal, or presence of a Hazardous Substance on, under, or about the Mortgaged Property, or any order, consent decree, or settlement relating to the cleanup of a Hazardous Substance, or any claims of loss, damage, liability, expense, or injury relating to or arising from, directly or indirectly, any disclosure by Lender to anyone of information, whether true or not, relative to a Hazardous Substance or Environmental Law violation, including, without limitation, Attorney Fees. This indemnity shall survive the release of this Deed of Trust (whether by payment of the Indebtedness secured by this Deed of Trust or foreclosure or action in lieu of foreclosure).

[*If applicable, add the following option*]

[*Option: Environmental audits*]

24.6. Environmental Audits.

[*Add one of the following alternatives*]

[*Alternative 1: Lender may demand environmental audit annually*]

From time to time, but no more than once in any 12-month period,

[*Alternative 2: Lender may demand environmental audit only if it has information of possible contamination*]

If Lender has received information indicating a reasonable possibility that Hazardous Substances contamination, use, generation, or storage exists on the Mortgaged Property or other properties in the area of the Mortgaged Property,

[*Continue*]

Lender may request and Borrower shall provide at its sole cost and expense within _ _[*e.g., 45 days*]_ _ after written request by Lender a report from a qualified engineering firm or other qualified consultant acceptable to Lender with respect to an investigation and audit of the Mortgaged Property (environmental audit), which environmental audit report shall be addressed to Lender and based on a thorough review of past and present uses, occupants, ownership, and tenancy of the Mortgaged Property and adjacent properties; soils or test boring reports from the construction of the Mortgaged Property; liaison with any Governmental Authority regarding known or suspected Hazardous Substances contamination, use, generation, or storage on the Mortgaged Property or other properties in the area; review of aerial photographs; and visual site inspection

noting unregulated fills, storage tanks or areas, ground discoloration or soil odors; and other investigative methods deemed necessary by the consultant to enable the consultant to report that there is no apparent or likely contamination of the Mortgaged Property by Hazardous Substances, whether such source of contamination is the Mortgaged Property or another property in the area; and Borrower shall, if deemed reasonably necessary to further investigate suspected or likely contamination, provide Lender with supplemental reports by acceptable qualified consultants of the analysis of core drilling or groundwater supplies from the Mortgaged Property, showing no contamination by Hazardous Substances.

24.7. Duty to Cure. If the environmental audit discloses matters unacceptable to Lender, Borrower shall cure such matters in a manner acceptable to Lender within _ _[*e.g., 180 days*]**_ _ after the environmental audit or supplemental report. Failure to cure such matters shall be a default under the Loan Documents and Lender may, without prior notice, declare all sums secured by this Deed of Trust, regardless of their stated due date(s), immediately due and payable, and may exercise all rights and remedies provided in this Deed of Trust.**

[*Alternative: No default if borrower diligently pursues cure*]

24.7 Duty to Cure. If the environmental audit discloses matters not acceptable to Lender, Borrower shall cure such matters in a manner acceptable to Lender within _ _[*e.g., 180 days*]**_ _ after such audit or supplemental report,**

[*Borrower will want to add the following option*]

[*Option: Extend cure period if cure diligently commenced*]

provided, however, that if the cure of any such matters cannot reasonably be made within such _ _[*e.g., 180-day*]**_ _ period and Borrower promptly and diligently commences to cure such default within that period, then the period to cure shall be deemed extended for up to an additional 90 days after the environmental audit or supplemental report as long as Borrower diligently and continuously proceeds to cure such matters to Lender's satisfaction.**

Comment: The borrower's environmental covenants, indemnities, representations, and warranties are often set out in a separate indemnity agreement.

Alternative 1 of paragraph 24.6 allows the lender to obtain an environmental investigation of the property at the borrower's expense every year. This provision should be necessary only if the property is known to be contaminated or the business operating on the property uses hazardous materials, and even then an annual investigation may be unwarranted. For most retail, commercial office, or multiresidential property, the borrower should try to eliminate this provision or at least try to condition environmental audits on the lender's knowledge or reasonable belief that contamination exists (see alternative 2).

The term "Environmental Laws" is defined in paragraph 1.5 of the deed of trust and "Hazardous Substance" is defined in paragraph 1.9 (both in §4.66). These are very broad definitions because the lender is trying to cover every law and every substance that could apply. Borrowers should understand that some normal business operations involve substances that are included in the definition of Hazardous Substances and should request the lender to add to the definition an exception such as that found in the optional language at the end of paragraph 1.9. On environmental contamination, see §4.47. On negotiating time periods in the deed of trust, see §4.9. On negotiating a reasonableness standard for exercise of the lender's discretion, see §4.10. On environmental indemnities generally, see chap 5A.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.90 I. Form: Trustee

§4.90 I. Form: Trustee

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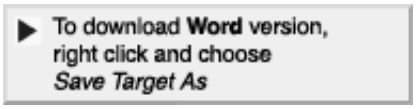

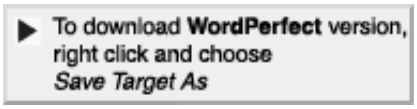

4.90-1 Trustee

25. Trustee. The Trustee shall be deemed to have accepted the terms of this trust when this Deed of Trust, duly executed and acknowledged, is made a public record as provided by law. The Trustee shall not be obligated to notify any party to this Deed of Trust of any pending sale under any other deed of trust or of any action or proceeding in which Borrower, Lender, or Trustee is a party, unless such sale relates to or reasonably might affect the Mortgaged Property, this Deed of Trust, Lender's security for the payment of the Indebtedness and the performance of the Obligations, or the rights or powers of Lender or Trustee under the Loan Documents, or unless such action or proceeding has been instituted by Trustee against the Mortgaged Property, Borrower, or Lender.

Comment: On the trustee's acceptance of its appointment, and the trustee's powers generally, see §4.48.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.91 1. Form: Power of Trustee to Reconvey or Consent

§4.91 1. Form: Power of Trustee to Reconvey or Consent

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4.91-1 Power of trustee to reconvey or consent

26. Power of Trustee to Reconvey or Consent. At any time, without liability and without notice to Borrower, on Lender's written request and presentation of the Note and this Deed of Trust to Trustee for endorsement, and without altering or affecting (a) the personal liability of Borrower or any other person for the payment of the Indebtedness secured by this Deed of Trust, or (b) the lien of this Deed of Trust on the remainder of the Mortgaged Property as security for the repayment of the full amount of the Indebtedness then or later secured by this Deed of Trust, (c) or any right or power of Lender or Trustee with respect to the remainder of the Mortgaged Property, Trustee may (i) reconvey or release any part of the Mortgaged Property from the lien of this Deed of Trust; (ii) approve the preparation or filing of any map or plat of the Mortgaged Property; (iii) join in the granting of any easement burdening the Mortgaged Property; or (iv) enter into any extension or subordination agreement affecting the Mortgaged Property or the lien of this Deed of Trust.

Comment: This paragraph describes the powers granted to the trustee but is based on the presumptions that the lender controls the trustee and that the trustee acts only as required by the lender. On the trustee's power to reconvey and other powers, see §4.48.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.92 2. Form: Duty to Reconvey

§4.92 2. Form: Duty to Reconvey

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4.92-1 Duty to reconvey

27. Duty to Reconvey. On Lender's written request reciting that all sums secured hereby have been paid, surrender of the Note and this Deed of Trust to Trustee for cancellation and retention by Trustee, and payment by Borrower of any reconveyance fees customarily charged by Trustee, Trustee shall reconvey, without warranty, the Mortgaged Property then held by Trustee under this Deed of Trust. The recitals in such reconveyance of any matters of fact shall be conclusive proof of their truthfulness. The grantee in such reconveyance may be described as "the person or persons legally entitled to the Mortgaged Property." Such request and reconveyance shall operate as a reassignment of the Rents assigned to Lender in this Deed of Trust.

Comment: On the trustee's duty to reconvey, see §4.48. This paragraph permits the trustee to retain the note and deed of trust, thus waiving the borrower's right to demand their return under CC §2941(a). On satisfaction of obligations, see §4.61.

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§4.93 3. Form: Substitution of Trustee

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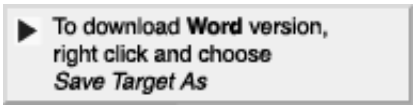

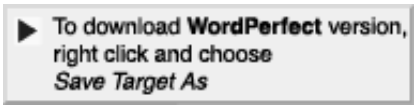

4.93-1 Substitution of trustee

28. Substitution of Trustee. Lender, at Lender's option, may from time to time, by written instrument, substitute a successor or successors to any Trustee named in or acting under this Deed of Trust, which instrument, when executed and acknowledged by Lender and recorded in the office of the Recorder of the county or counties in which the Mortgaged Property is located, shall constitute conclusive proof of the proper substitution of such successor Trustee or Trustees, who shall, without conveyance from the predecessor Trustee, succeed to all right, title, estate, powers, and duties of such predecessor Trustee, including, without limitation, the power to reconvey the Mortgaged Property. To be effective, the instrument must contain the names of the original Borrower, Trustee, and Lender under this Deed of Trust, the book and page or instrument or document number at which, and the county or counties in which, this Deed of Trust is recorded, and the name and address of the substitute Trustee. If any notice of default has been recorded under this Deed of Trust, this power of substitution cannot be exercised until all costs, fees, and expenses of the then acting Trustee have been paid. On such payment, the then acting Trustee shall endorse receipt of the payment on the instrument of substitution. The procedure provided in this paragraph for substitution of Trustees is not exclusive of other provisions for substitution provided by Governmental Requirements.

Comment: On substitution of trustee, see §4.49.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.94 J. Form: No Waiver by Lender

§4.94 J. Form: No Waiver by Lender

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4.94-1 No waiver by lender

29. No Waiver by Lender. No waiver by Lender of any right or remedy provided by the Loan Documents or Governmental Requirements shall be effective unless such waiver is in writing and signed by two authorized officers of Lender. Waiver by Lender of any right or remedy granted to Lender under the Loan Documents or Governmental Requirements as to any transaction or occurrence shall not be deemed a waiver of any future transaction or occurrence. The acceptance of payment of any sum secured by this Deed of Trust after its due date, or the payment by Lender of any Indebtedness or the performance by Lender of any Obligations of Borrower under the Loan Documents, on Borrower's failure to do so, or the addition of any payment so made by Lender to the Indebtedness secured by this Deed of Trust, or the exercise of Lender's right to enter the Mortgaged Property and receive and collect the Rents from it, or the assertion by Lender of any other right or remedy under the Loan Documents, shall not constitute a waiver of Lender's right to require prompt performance of all other Obligations of Borrower under the Loan Documents and payment of the Indebtedness, or to exercise any other right or remedy under the Loan Documents for any failure by Borrower to timely and fully pay the Indebtedness and perform its Obligations under the Loan Documents. Lender may waive any right or remedy under the Loan Documents or Governmental Requirements without notice to or consent from Borrower, any guarantor of the Indebtedness and of Borrower's Obligations under the Loan Documents, or any holder or claimant of a lien or other interest in the Mortgaged Property that is junior to the lien of this Deed of Trust, and without incurring liability to Borrower or any other person by so doing.

Comment: This paragraph limits the effect of any action or inaction by the lender that may be claimed to be a waiver of some performance owed by the borrower. It also provides that any waiver by the lender must be in writing and signed by two officers, so that any comment or statement made by an employee of the lender would not be misconstrued as a waiver of performance by the borrower. See similar requirement in paragraph 30 in §4.95 on consents and modifications.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.95 K. Form: Lender's Rights to Modify Loan

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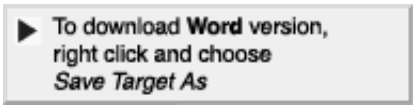

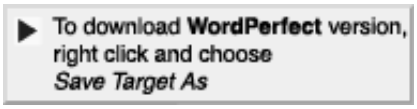

4.95-1 Lender's rights to modify loan

30. Consents and Modifications; Borrower and Lien Not Released. Despite Borrower's default in the payment of any Indebtedness secured by this Deed of Trust or in the performance of any Obligations under this Deed of Trust or Borrower's breach of any obligation, covenant, or agreement in the Loan Documents, Lender, at Lender's option, without notice to or consent from Borrower, any guarantor of the Indebtedness and of Borrower's Obligations under the Loan Documents, or any holder or claimant of a lien or interest in the Mortgaged Property that is junior to the lien of this Deed of Trust, and without incurring liability to Borrower or any other person by so doing, may from time to time (a) extend the time for payment of all or any portion of Borrower's Indebtedness under the Loan Documents; (b) accept a renewal note or notes, or release any person from liability, for all or any portion of such Indebtedness; (c) agree with Borrower to modify the terms and conditions of payment under the Loan Documents; (d) reduce the amount of the monthly installments due under _ _[*e.g., paragraph 9*]_ _ of this Deed of Trust; (e) reconvey or release other or additional security for the repayment of Borrower's Indebtedness under the Loan Documents; (f) approve the preparation or filing of any map or plat with respect to the Mortgaged Property; (g) enter into any extension or subordination agreement affecting the Mortgaged Property or the lien of this Deed of Trust; and (h) agree with Borrower to modify the term, the rate of interest, or the period of amortization of the Note or alter the amount of the monthly installments payable under the Note. No action taken by Lender under this paragraph shall be effective unless it is in writing, subscribed by Lender, and, except as expressly stated in such writing, no such action will impair or affect (i) Borrower's obligation to pay the Indebtedness secured by this Deed of Trust and to observe all Obligations of Borrower contained in the Loan Documents; (ii) the guaranty of any Person of the payment of the Indebtedness secured by this Deed of Trust; or (iii) the lien or priority of the lien of this Deed of Trust. At Lender's request, Borrower shall promptly pay Lender a reasonable service charge, together with all insurance premiums and Attorney Fees as Lender may have advanced, for any action taken by Lender under this paragraph.

Whenever Lender's consent or approval is specified as a condition of any provision of this Deed of Trust, such consent or approval shall not be effective unless such consent or approval is in writing, signed by two authorized officers of Lender.

Comment: Most lenders require a provision requiring any lender consents and approvals to be in writing, to prevent disputes about what one person may have said to another. On consents and modifications, see §4.50.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.96 L. Form: Borrower's Waiver of Right of Offset

§4.96 L. Form: Borrower's Waiver of Right of Offset

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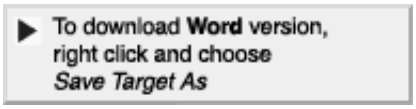

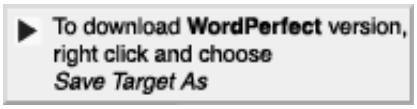

4.96-1 Borrower's waiver of right of offset

31. Waiver of Right of Offset. No portion of the Indebtedness secured by this Deed of Trust shall be or be deemed to be offset or compensated by all or any part of any claim, cause of action, counterclaim, or cross-claim, whether liquidated or unliquidated, that Borrower may have or claim to have against Lender. Borrower hereby waives, to the fullest extent permitted by Governmental Requirements, the benefits of California Code of Civil Procedure §431.70, which provides:

> **Where cross-demands for money have existed between persons at any point in time when neither demand was barred by the statute of limitations, and an action is thereafter commenced by one such person, the other person may assert in the answer the defense of payment in that the two demands are compensated so far as they equal each other, notwithstanding that an independent action asserting the person's claim would at the time of filing the answer be barred by the statute of limitations. If the cross-demand would otherwise be barred by the statute of limitations, the relief accorded under this section shall not exceed the value of the relief granted to the other party. The defense provided by this section is not available if the cross-demand is barred for failure to assert it in a prior action under Section 426.30. Neither person can be deprived of the benefits of this section by the assignment or death of the other. For the purposes of this section, a money judgment is a "demand for money" and, as applied to a money judgment, the demand is barred by the statute of limitations when enforcement of the judgment is barred under Chapter 3 (commencing with Section 683.010) of Division 1 of Title 9.**

Comment: On waiver of right of offset, see §4.51.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.97 M. Form: Future Advances

§4.97 M. Form: Future Advances

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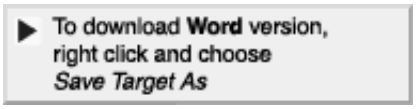

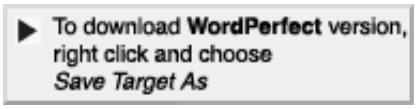

4.97-1 Future advances

32. Future Advances. On request by Borrower, Lender, at Lender's option, may make future advances to Borrower. All such future advances, with interest, shall be added to and become a part of the Indebtedness secured by this Deed of Trust when evidenced by promissory note(s) reciting that such note(s) are secured by this Deed of Trust.

Comment: On future advances, see §4.52.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.98 N. Form: Prepayment

§4.98 N. Form: Prepayment

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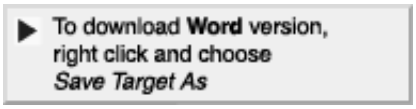

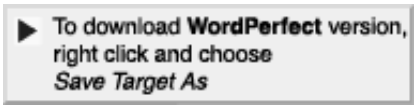

4.98-1 Prepayment

33. Prepayment. If the Note secured by this Deed of Trust provides for a fee or charge as consideration for the acceptance of prepayment of principal, Borrower agrees to pay said fee or charge if the Indebtedness or any part of it shall be paid, whether voluntarily or involuntarily, before the due date stated in the Note, even if Borrower has defaulted in payment or in the performance of any agreement under this Deed of Trust and Lender, for that reason or by reason of _ _[*e.g., paragraphs 20 and 21*]_ _ of this Deed of Trust, shall have declared all sums secured by this Deed of Trust immediately due and payable.

Comment: On prepayment, see §4.53.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.99 O. Form: Additional Borrower Representations

§4.99 O. Form: Additional Borrower Representations

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4.99-1 Additional borrower representations

34. Additional Borrower Representations. To induce Lender to enter into this Deed of Trust, the Note, and the other Loan Documents and to make the Loan, Borrower makes the following representations and warranties, which are deemed made as of both the date and the recordation of this Deed of Trust:

34.1. Capacity. Borrower and the individuals executing Loan Documents on Borrower's behalf have the full power, authority, and legal right to execute and deliver, and to perform and observe the provisions of this Deed of Trust, the Note, the other Loan Documents, and any other document, agreement, certificate, or instrument executed in connection with the Loan, and to carry out the contemplated transactions.

34.2. Authority and Enforceability. Borrower's execution, delivery, and performance of this Deed of Trust, the Note, the other Loan Documents, and any other document, agreement, certificate, or instrument executed in connection with the Loan have been duly authorized by all necessary corporate or other business entity action and do not and shall not require any registration with, consent, or approval of, notice to, or any action by any Person or Governmental Authority. Borrower has obtained or will obtain on or before the recordation of this Deed of Trust all necessary Governmental Authority and other approvals necessary for Borrower to comply with the Loan Documents. This Deed of Trust, the Note, and the other Loan Documents executed in connection with the Loan, when executed and delivered by Borrower, shall constitute the legal, valid, binding, and joint and several obligations of Borrower enforceable in accordance with their respective terms.

34.3. Compliance With Other Instruments. The execution and delivery of this Deed of Trust and the other Loan Documents, and compliance with their respective terms, and the issuance of the Note and other Loan Documents as contemplated in this Deed of Trust, shall not result in a breach of any of the terms or conditions of, or result in the imposition of, any lien, charge, or encumbrance (except as created by this Deed of Trust and the other Loan Documents) on any properties of Borrower, or constitute a default (with due notice or lapse of time or both) or result in an occurrence of an event for which any holder or holders of indebtedness may declare the same due and payable under, any indenture, agreement, order, judgment, or instrument to which Borrower is a party or by which Borrower or its properties may be bound or affected.

34.4. Compliance With Law. The execution and delivery of this Deed of Trust, the Note, and the other Loan Documents, or any other document, agreement, certificate, or instrument to which Borrower is bound in connection with the Loan, do not conflict with, result in a breach or default under, or create any lien or charge under any provision of any Governmental Requirements to which it is subject and shall not violate any of the Governmental Requirements.

34.5. Material Adverse Events. Since the date of the financial statements delivered to Lender before recordation of this Deed of Trust, neither the condition (financial or otherwise) nor the business of Borrower and the Mortgaged Property have been materially adversely affected in any way.

34.6. Litigation. There are no actions, suits, investigations, or proceedings pending or, to Borrower's knowledge after due inquiry and investigation, threatened against or affecting Borrower at law or in equity, before or by any Person or Governmental Authority, that, if adversely determined, would have a material adverse effect on the business, properties, or condition (financial or otherwise) of Borrower or on the validity or enforceability of this Deed of Trust, any of the other Loan Documents, or the ability of Borrower to perform under any of the Loan Documents.

34.7. No Untrue Statements. All statements, representations, and warranties made by Borrower in this Deed

of Trust or any other Loan Document and any other agreement, document, certificate, or instrument previously furnished or to be furnished by Borrower to Lender under the Loan Documents (a) are and shall be true, correct, and complete in all material respects at the time they were made and on and as of the recordation of this Deed of Trust, (b) do not and shall not contain any untrue statement of a material fact, and (c) do not and shall not omit to state a material fact necessary to make the information in them neither misleading nor incomplete. Borrower understands that all such statements, representations, and warranties shall be deemed to have been relied on by Lender as a material inducement to make the Loan.

34.8. Policies of Insurance. Each copy of the insurance policies relating to the Mortgaged Property delivered to Lender by Borrower (a) is a true, correct, and complete copy of the respective original policy in effect on the date of this Deed of Trust, and no amendments or modifications of said documents or instruments not included in such copies have been made, except as stated in this _ _[*e.g., paragraph 34.8*]_ _ and (b) has not been terminated and is in full force and effect. Borrower is not in default in the observance or performance of its material obligations under said documents or instruments and Borrower has done all things required to be done as of the date of this Deed of Trust to keep unimpaired its rights thereunder.

34.9. Financial Statements. All financial statements furnished to Lender are true and correct in all material respects, are prepared in accordance with generally accepted accounting principles, and do not omit any material fact the omission of which makes such statement or statements misleading. There are no facts that have not been disclosed to Lender by Borrower in writing that materially or adversely affect or could potentially in the future affect the Mortgaged Property or the business prospects, profits, or condition (financial or otherwise) of Borrower or any guarantor or Borrower's abilities to perform the Obligations and pay the Indebtedness.

34.10. Water Rights. (a) Borrower is the sole owner of record of the Water Rights; (b) the Water Rights are appurtenant to the Mortgaged Property and are free and clear of all liens and encumbrances except as set forth in the title report described in _ _[*e.g., paragraph 1.22*]_ _; (c) the Water Rights are sufficient to satisfy all water requirements of the development of the Mortgaged Property as presently contemplated; (d) the Water Rights include all water rights appurtenant to the Mortgaged Property; (e) Borrower has received a water service commitment from the _ _[*name*]_ _ Water District guaranteeing water service for the Mortgaged Property in an amount necessary to satisfy the requirements for such property in its currently contemplated final state of development; and (f) on recordation of this Deed of Trust with the county recorder, Lender shall have a valid, first priority, perfected security interest in the Water Rights.

34.11. Taxes. Borrower has filed or caused to be filed all tax returns that are required to be filed by Borrower under the Governmental Requirements of each Governmental Authority with taxing power over Borrower, and Borrower has paid, or made provision for the payment of, all taxes, assessments, fees, and other governmental charges that have or may have become due under said returns, or otherwise, or under any assessment received by Borrower except that such taxes, if any, as are being contested in good faith and as to which adequate reserves (determined in accordance with generally accepted accounting principles) have been provided.

34.12. Title to Mortgaged Property and Zoning. As of the date of recordation of this Deed of Trust, Borrower holds full legal and equitable title to the Mortgaged Property, subject only to the Permitted Encumbrances. The Mortgaged Property is zoned _ _[*type of zoning*]_ _ under applicable zoning laws. Adequate water, telephone, gas and electrical supply, storm and sanitary sewerage or septic facilities, as required, and any other required public utilities are available for the Mortgaged Property. Adequate means of access exist between the Mortgaged Property and public streets for pedestrians and motor vehicles. The Mortgaged Property currently complies with all Governmental Requirements.

34.13. Leases. If the Mortgaged Property includes a leasehold estate, Borrower has not and shall not surrender, terminate, cancel, waive, accept waiver, change, supplement, grant subleases of, alter, surrender, or amend, and shall comply with all terms, covenants, and conditions in the Leasehold.

34.14. Further Acts. Borrower shall, at its sole cost and expense, and without expense to Trustee or Lender, do, execute, acknowledge, and deliver all and every such further acts, deeds, conveyances, deeds of trust, mortgages, assignments, notices of assignments, transfers, and assurances as Trustee or Lender shall from time to time require, for the purpose of better assuring, conveying, assigning, transferring, pledging, mortgaging, warranting, and confirming to Trustee the Mortgaged Property and rights, and as to Lender the security interest as to the Personalty, conveyed or assigned by this Deed of Trust or intended now or later so

to be, or for carrying out the intention or facilitating the performance of the terms of this Deed of Trust, or for filing, registering, or recording this Deed of Trust and, on demand, shall execute and deliver, and authorizes Lender to execute in the name of Borrower, to the extent it may lawfully do so, one or more financing statements, chattel mortgages, or comparable security instruments, to evidence more effectively the lien of this Deed of Trust on the Mortgaged Property.

34.15. Filing Fees. Borrower shall pay all filing, registration, or recording fees, all Governmental Authority stamp taxes and other fees, taxes, duties, imposts, assessments, and all other charges incident to, arising from, or in connection with the preparation, execution, delivery, and enforcement of the Note, this Deed of Trust, the other Loan Documents, any supplemental deed of trust or mortgage, or any instrument of further assurance.

34.16. Entity Compliance. As long as it is the owner of the Mortgaged Property, Borrower, if a corporation, limited liability company, or partnership, shall do all things necessary to preserve and keep in full force and effect its existence, franchises, rights, and privileges as such entity under the laws of the state of its incorporation or formation, and shall comply with all Governmental Requirements of any Governmental Authority applicable to Borrower or to the Mortgaged Property or any part of it.

34.17. No Purchase of Security. Borrower represents and warrants that this Deed of Trust and the Indebtedness secured by this Deed of Trust is for the sole purpose of conducting or acquiring a lawful business, profession, or commercial activity or for the acquisition or management of real or personal property as a commercial investment, and all proceeds of such Indebtedness shall be used for said business or commercial investment purpose. Such proceeds shall not be used to purchase any security within the meaning of the Securities Exchange Act of 1934, as amended, or any regulation issued under that Act, including, without limitation, Regulations G, T, and X of the Board of Governors of the Federal Reserve System.

Comment: On additional borrower representations, see §4.54. The author believes that the borrower would have little luck limiting these representations to "best of knowledge." Although useful if a legal entity wants to limit knowledge to certain individuals involved in the transaction so that the chance personal knowledge of an employee unrelated to the transaction is not imputed to the legal entity, frequently using a "best knowledge" limitation simply creates litigation issues. The borrower's main concern is that the lender will notice a default if something is not as represented. If this happens, the borrower can argue "lack of impairment of security" to try to stop a foreclosure for a trivial breach. On impairment of security, see §4.27.

A lender who knowingly makes a loan for the purpose of investing in securities is subject to certain requirements of the Securities Exchange Act of 1934. Real property lenders do not intentionally make loans secured by real property so that the borrower can invest in securities and do not want to be subject to the federal securities law. Consequently, paragraph 34.17 contains a covenant that the loan is not for the purpose of investing in securities.

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P. Miscellaneous

§4.100 1. Form: Governing Law

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4.100-1 Governing law

35. Governing Law. This instrument shall be deemed to have been made in the State of California, and the validity of this Deed of Trust and the other Loan Documents, their construction, interpretation, and enforcement, and the parties' rights under such documents and concerning the Mortgaged Property, shall be decided under, governed by, and construed in accordance with the laws of the State of California. The parties agree that all actions or proceedings arising in connection with this Deed of Trust and the other Loan Documents shall be tried and litigated only in the state courts located in the County of _ _[*name*]_ _, State of California, or the federal courts located in the _ _[*e.g., Southern*]_ _ District of California. Borrower waives any right Borrower may have to assert the doctrine of forum non conveniens or to object to such venue.

Comment: On governing law, see §4.55.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.101 2. Form: Request for Notice of Default

§4.101 2. Form: Request for Notice of Default

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4.101-1 Request for notice of default

36. Request for Notice of Default. The undersigned Borrower requests that a copy of any notice of default and any notice of sale under this Deed of Trust be mailed to Borrower at its address specified in _ _[*e.g., paragraph 42*]**_ _.**

Comment: On request for notice of default, see §4.56.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.102 3. Form: Taxation

§4.102 3. Form: Taxation

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4.102-1 Taxation

37. Taxation of Deeds of Trust. In the event of the enactment of any law deducting from the value of the Mortgaged Property any mortgage lien on it, or imposing on Lender the payment of all or part of the taxes, charges, or assessments previously paid by Borrower under this Deed of Trust, or changing the law relating to the taxation of mortgages, debts secured by mortgages, or Lender's interest in the Mortgaged Property so as to impose new incidents of tax on Lender, then Borrower shall pay such taxes or assessments or shall reimburse Lender for them; provided, however, that if in the opinion of Lender's counsel such payment cannot lawfully be made by Borrower, then Lender may, at Lender's option, declare all sums secured by this Deed of Trust to be immediately due and payable without notice to Borrower. Lender may invoke any remedies permitted by this Deed of Trust.

Comment: This paragraph protects the lender from a future change in the method of taxing real property that would impose part of the tax (*e.g.*, ad valorem, transfer) on the lender. The clause requires the borrower to pay any tax levied against the lender, but if the law forbids this, the lender may accelerate the loan. Thus far, the invocation of this clause in California has never been needed, and it is doubtful that the acceleration remedy would be judicially sanctioned.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.103 4. Form: Mechanics' Liens

§4.103 4. Form: Mechanics' Liens

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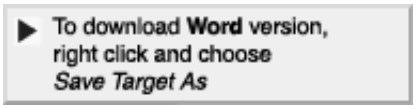

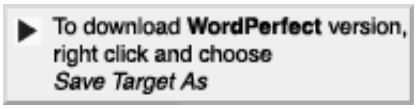

4.103-1 Mechanics' liens

38. Mechanics' Liens. Borrower shall pay from time to time when due, all lawful claims and demands of mechanics, materialmen, laborers, and others that, if unpaid, might result in, or permit the creation of, a lien on the Mortgaged Property or any part of it, or on the Rents arising therefrom, and in general shall do or cause to be done everything necessary so that the lien and security interest of this Deed of Trust shall be fully preserved, at Borrower's expense, without expense to Lender; provided, however, that if Governmental Requirements empower Borrower to discharge of record any mechanics', laborer's, materialman's, or other lien against the Mortgaged Property by the posting of a bond or other security, Borrower shall not have to make such payment if Borrower posts such bond or other security on the earlier of (a) _ _[*e.g., 10 days*]_ _ after the filing or recording of same or (b) within the time prescribed by law, so as not to place the Mortgaged Property in jeopardy of a lien or forfeiture.

Comment: This paragraph provides that the borrower will pay or bond against claims of parties who have the right to record a mechanics' lien against the mortgaged property. Although subsequent mechanics' liens are junior to the deed of trust, lenders view them as evidence that the borrower is having financial trouble. Having this clause allows the lender to treat subsequently recorded mechanics' liens as events of default if the borrower does not promptly take care of them. For a complete discussion of mechanics' liens, see California Mechanics' Liens and Related Construction Remedies (3d ed Cal CEB 1998).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.104 5. Form: Financial Covenant [Deleted]

§4.104 5. Form: Financial Covenant [Deleted]

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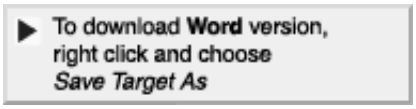

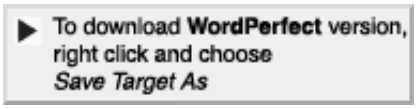

This section has been deleted from the form. See §3.104.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.105 6. Form: Brokerage

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4.105-1 Brokerage

39. Brokerage.

[*If applicable, add the following option*]

[*Option: If the borrower has used a Mortgage broker*]

Except for _ _[*name of agent*]_ _, for whose commission and fees Borrower has exclusively agreed to pay, and against which Borrower indemnifies Lender,

[*Continue*]

Borrower represents and warrants to Lender that Borrower has not dealt with any Person who is or may be entitled to any finder's fee, brokerage commission, loan commission, or other sum in connection with the execution of this Deed of Trust, the consummation of the transactions contemplated by this Deed of Trust, or the making of the Loan secured by this Deed of Trust by Lender to Borrower, and Borrower indemnifies and agrees to hold Lender harmless from and against any and all loss, liability, or expense, including court costs and Attorney Fees, that Lender may suffer or sustain if such warranty or representation proves inaccurate in whole or in part.

Comment: Occasionally, borrowers find a lender through the services of a loan broker or finder and lenders sometimes use a loan broker to find a borrower. If the use of a loan broker or finder is known to both parties, the compensation of the broker or finder is covered in the loan documents or escrow instructions. The foregoing provision assumes that no loan broker is involved, at least to the lender's knowledge: the borrower represents that there is no loan broker or finder involved and agrees to indemnify the lender from any claim by a loan broker or finder. This provision may be included in the deed of trust or placed in a separate loan agreement. A borrower who has not used a loan broker or finder should not object to the provision. If the borrower did use a loan broker, the optional language should be used. On brokers and finders generally, see California Real Estate Brokers: Law and Litigation §§3.5, 8.15-8.18 (Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.106 7. Form: Liability for Acts or Omissions

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4.106-1 Liability for acts or omissions

40. Liability for Acts or Omissions. Lender shall not be liable or responsible for its acts or omissions under this Deed of Trust, except for Lender's own gross negligence or willful misconduct, or be liable or responsible for any acts or omissions of any agent, attorney, or employee of Lender, if selected with reasonable care.

Comment: This provision attempts to limit the liability of the party drafting the document to cases of gross negligence and willful misconduct. The provision also attempts to limit any liability of the lender for actions of its agents, if selected with reasonable care. The borrower will likely try to eliminate this entire provision and particularly the limitation for agents' acts or omissions (which may not be enforceable in any event).

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§4.107 8. Form: Notices

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4.107-1 Notices

41. Notices. Except for any notice required by Governmental Requirements to be given in another manner, (a) all notices required or permitted by the Loan Documents shall be in writing; (b) each notice shall be sent (i) for personal delivery by a delivery service that provides a record of the date of delivery, the individual to whom delivery was made, and the address where delivery was made; (ii) by certified United States mail, postage prepaid, return receipt requested; or (iii) by nationally recognized overnight delivery service, marked for next-business-day delivery; and (c) all notices shall be addressed to the appropriate party at its address as follows or such other addresses as may be designated by notice given in compliance with this provision:

Lender: _____
_____
_____

Re: Loan No. _____

Borrower: _____
_____
_____

Notices will be deemed effective on the earliest of (a) actual receipt; (b) rejection of delivery; or (c) if sent by certified mail, the third day on which regular United States mail delivery service is provided after the day of mailing or, if sent by overnight delivery service, on the next day on which such service makes next-business-day deliveries after the day of sending.

To the extent permitted by Governmental Requirements, if there is more than one Borrower, notice to any Borrower shall constitute notice to all Borrowers. For notice purposes, Borrower agrees to keep Lender informed at all times of Borrower's current address(es).

Comment: The foregoing notice provision requires mailed notice to both parties with the notice to lender by certified mail. Institutional lenders often require certified mailed notice from the borrower because they are concerned that an important notice from the borrower may be misdelivered or lost, given the volume of mail they receive daily. See Comment on notices in promissory note in §3.71.

If there is a conflict between the provision in the note and the one in the deed of trust, the note provision normally controls. *Pacific Fruit Exch. v Duke* (1930) 103 CA 340, 284 P 729. Counsel should of course avoid such conflicts. On notices, see §4.56.

For purposes of a notice of default or notice of sale, the notice must be delivered, in accordance with the requirements of CC §2924b(b)(1), to the last known address of each trustor or mortgagor, which is the last business or residence physical address actually known by the person authorized to record the notice of default or notice of sale. CC §2924b(b)(3). For these purposes, an address is "actually known" if it is contained in the original deed of trust or mortgage or subsequent notice from the trustor or mortgagor, pursuant to the deed of trust or mortgage, of a change of physical address of the trustor or mortgagor. CC §2924b(b)(3). For these purposes, "physical address" does not include an e-mail or other form of electronic address. CC §2924b(b)(3).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.108 9. Form: Statement of Obligations

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4.108-1 Statement of obligations

42. Statement of Obligations. Except as otherwise provided by Governmental Requirements, at Lender's request, Borrower shall promptly pay to Lender such fee as may then be provided by law as the maximum charge for each statement of obligations, Lender's statement, Lender's demand, payoff statement, or other statement on the condition of, or balance owed, under the Note or secured by this Deed of Trust.

Comment: The fee payable by the borrower for a beneficiary statement or a payoff demand is set by CC §2943(e)(6), which requires the borrower to pay the amount of the statutory fee in effect at the time the lender provides the statement. A letter from a lender to an escrow holder that does not satisfy the statutory requirements of CC §2943 for payoff demand statements cannot be construed as a payoff demand. Nor can a payoff demand statement be relied on by a third party (*i.e.,* a junior lender), because only borrowers are benefited by the statute. *California Nat'l Bank v Havis* (2004) 120 CA4th 1122, 1134, 16 CR3d 245.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.109 10. Form: Application of Payments

§4.109 10. Form: Application of Payments

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4.109-1 Application of payments

43. Application of Payments. Except as otherwise expressly provided by Governmental Requirements or any other provision of this Deed of Trust, all payments received by Lender from Borrower under the Loan Documents shall be applied by Lender in the following order: (a) costs, fees, charges, and advances paid or incurred by Lender or payable to Lender and interest under any provision of this Note or the Deed of Trust, in such order as Lender, in its sole and absolute discretion, elects, (b) interest payable under the Note, and (c) principal under the Note.

Comment: This provision should be the same as any similar provision in the promissory note. Other provisions of the deed of trust cover the application of money received from sources other than the borrower, such as insurance proceeds. See §§4.27-4.28.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.110 11. Form: Remedies Are Cumulative

§4.110 11. Form: Remedies Are Cumulative

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4.110-1 Remedies are cumulative

44. Remedies Are Cumulative. Each remedy in this Deed of Trust is separate and distinct and is cumulative to all other rights and remedies provided by this Deed of Trust or by Governmental Requirements, and each may be exercised concurrently, independently, or successively, in any order whatsoever.

Comment: This provision would not allow the lender to avoid making an election of remedies at the appropriate time when the lender is concurrently pursuing a judicial or nonjudicial foreclosure. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 2-3 (4th ed Cal CEB 2009). Lenders must be aware that their remedies under the deed of trust are limited by California's antideficiency and one-action statutes. For a thorough discussion of these statutes, see Mortgage Deed of Trust Foreclosure, chaps 4-5.

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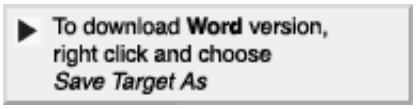
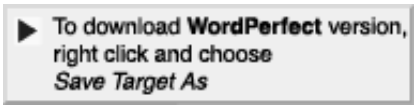
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.111 12. Form: Joint and Several Obligations

§4.111 12. Form: Joint and Several Obligations

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.





4.111-1 Joint and several obligations

45. Obligations of Borrower Joint and Several. If more than one Person is named as Borrower, each obligation of Borrower under this Deed of Trust shall be the joint and several obligations of each such Person.

Comment: On joint and several liability, see §3.47.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.112 13. Form: Severability

§4.112 13. Form: Severability

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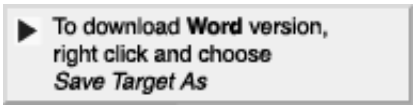

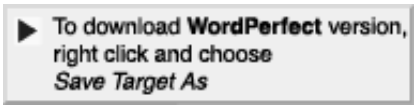

4.112-1 Severability

46. Severability. If any provision of the Loan Documents, or the application of them to the circumstances, is held void, invalid, or unenforceable by a court of competent jurisdiction, the Loan Documents, and the applications of such provision to other parties or circumstances, shall not be affected thereby, the provisions of the Loan Documents being severable in any such instance.

Comment: On severability, see §3.54.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.113 14. Form: Delegation of Authority

§4.113 14. Form: Delegation of Authority

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4.113-1 Delegation of authority

47. <u>Delegation of Authority</u>. Whenever this Deed of Trust provides that Borrower authorizes and appoints Lender as Borrower's attorney-in-fact to perform any act for or on behalf of Borrower or in the name, place, and stead of Borrower, Borrower expressly understands and agrees that this authority shall be deemed a power coupled with an interest and such power shall be irrevocable.

Comment: On delegation of authority, see §4.57.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.114 15. Form: General Provisions

§4.114 15. Form: General Provisions

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4.114-1 General provisions

48. General Provisions.

48.1. Successors and Assigns. Subject to _ _[*e.g., paragraphs 19 and 20*]_ _ of this Deed of Trust, this Deed of Trust applies to, inures to the benefit of, and binds, the respective heirs, legatees, devisees, administrators, executors, successors, and assigns of each party to this Deed of Trust.

48.2. Meaning of Certain Terms. As used in this Deed of Trust and unless the context otherwise provides, the words "herein," "hereunder" and "hereof" mean and include this Deed of Trust as a whole, rather than any particular provision of it.

48.3. Authorized Agents. In exercising any right or remedy, or taking any action provided in this Deed of Trust, Lender may act through its employees, agents, or independent contractors, as Lender expressly authorizes.

48.4. Gender and Number. Wherever the context so requires in this Deed of Trust, the masculine gender includes the feminine and neuter, the singular number includes the plural, and vice versa.

48.5. Captions. Captions and paragraph headings used in this Deed of Trust are for convenience of reference only, are not a part of this Deed of Trust, and shall not be used in construing it.

48.6. Time Is of the Essence. As a material inducement and consideration to the parties entering into this Deed of Trust, and but for this provision the parties would not enter into this Deed of Trust, the parties agree that the performance in a timely manner of each deadline set forth in this Deed of Trust before its expiration is of crucial importance to the parties. Failure by a party to timely perform an obligation before the deadline set forth in this Deed of Trust (no matter for what reason, nor how soon thereafter it may have been performed, nor the lack of prejudice to the other party as the result of such nonperformance) shall result in a default by the nonperforming party or the failure of a condition, as appropriate. The parties expressly waive any equitable relief with respect to a missed deadline.

Comment: This paragraph includes various common contract interpretation provisions, including a successors and assigns clause. Because of the due-on-sale provision (see §4.43), however, the lender should note that the successor provision does not limit the lender's right to enforce the due-on-sale clause.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.115 Q. Form: Dispute Resolution: Waiver of Right to Jury Trial; Alternatives

§4.115 Q. Form: Dispute Resolution: Waiver of Right to Jury Trial; Alternatives

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49. Dispute Resolution: Waiver of Right to Jury Trial

4.115-1 Dispute resolution: Waiver of right to jury trial

49.1 WAIVER OF RIGHT TO JURY TRIAL. TO THE EXTENT PERMITTED BY APPLICABLE LAW, BORROWER AND LENDER AGREE TO WAIVE THEIR RESPECTIVE RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED ON OR ARISING FROM THIS DEED OF TRUST. THE SCOPE OF THIS WAIVER IS INTENDED TO BE ALL-ENCOMPASSING OF ANY AND ALL DISPUTES THAT MAY BE FILED IN ANY COURT AND THAT RELATE TO THE SUBJECT MATTER OF THIS TRANSACTION, INCLUDING, WITHOUT LIMITATION, CONTRACT CLAIMS, TORT CLAIMS, BREACH OF DUTY CLAIMS, AND ALL OTHER COMMON LAW AND STATUTORY CLAIMS. BORROWER AND, BY ITS ACCEPTANCE OF THE BENEFITS OF THIS DEED OF TRUST, LENDER EACH (A) ACKNOWLEDGES THAT THIS WAIVER IS A MATERIAL INDUCEMENT FOR BORROWER AND LENDER TO ENTER INTO A BUSINESS RELATIONSHIP, THAT BORROWER AND LENDER HAVE ALREADY RELIED ON THIS WAIVER BY ENTERING INTO THIS DEED OF TRUST OR ACCEPTING ITS BENEFITS, AS THE CASE MAY BE, AND THAT EACH SHALL CONTINUE TO RELY ON THIS WAIVER IN THEIR RELATED FUTURE DEALINGS, AND (B) FURTHER WARRANTS AND REPRESENTS THAT EACH HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL, AND THAT EACH KNOWINGLY AND VOLUNTARILY WAIVES ITS JURY TRIAL RIGHTS FOLLOWING CONSULTATION WITH LEGAL COUNSEL. THIS WAIVER IS IRREVOCABLE, IT MAY NOT BE MODIFIED EITHER ORALLY OR IN WRITING, AND THIS WAIVER SHALL APPLY TO ANY SUBSEQUENT AMENDMENTS, RENEWALS, SUPPLEMENTS, OR MODIFICATIONS TO THIS DEED OF TRUST.

4.115-2 Optional addition to 4.115-1: Arbitration alternative

49.2 ARBITRATION. TO THE EXTENT A PREDISPUTE WAIVER OF THE RIGHT TO TRIAL BY JURY IS NOT ENFORCEABLE UNDER APPLICABLE LAW, ANY AND ALL DISPUTES, CONTROVERSIES OR CLAIMS ARISING OUT OF OR RELATING TO THIS DEED OF TRUST AND OTHER LOAN DOCUMENTS OR TRANSACTIONS CONTEMPLATED THEREBY, INCLUDING, WITHOUT LIMITATION, THE MAKING, PERFORMANCE, OR INTERPRETATION OF THIS DEED OF TRUST OR OTHER LOAN DOCUMENTS, SHALL BE RESOLVED BY BINDING ARBITRATION. UNLESS OTHERWISE AGREED ON, THE ARBITRATION SHALL BE CONDUCTED IN ACCORDANCE WITH THE THEN-CURRENT ARBITRATION PROCEDURES SET FORTH IN CALIFORNIA CODE OF CIVIL PROCEDURE §§1281-1284.3 AND LOCAL SUPPLEMENTARY RULES THEN IN EFFECT. JUDGMENT ON THE ARBITRATION AWARD MAY BE ENTERED IN ANY COURT HAVING JURISDICTION. UNLESS OTHERWISE AGREED BY THE PARTIES, THE ARBITRATION SHALL BE HELD BEFORE A SINGLE ARBITRATOR SELECTED AS FOLLOWS: THE DISPUTING PARTIES SHALL, WITHIN TEN (10) BUSINESS DAYS FROM THE DATE ARBITRATION IS REQUESTED BY EITHER PARTY, AGREE UPON AN ARBITRATOR. IF THE PARTIES CANNOT SO AGREE, THEN EACH PARTY, WITHIN FIVE (5) BUSINESS DAYS THEREAFTER, SHALL NAME AN ARBITRATOR WHO SHALL BE AN ATTORNEY LICENSED TO PRACTICE IN CALIFORNIA AND EXPERIENCED AND QUALIFIED IN REAL ESTATE MATTERS OF THE TYPE CONTEMPLATED BY THIS DEED OF TRUST AND OTHER LOAN DOCUMENTS OR A RETIRED CALIFORNIA SUPERIOR OR APPELLATE COURT JUDGE. THOSE TWO NAMED ARBITRATORS SHALL THEN, WITHIN FIVE (5) BUSINESS DAYS, SELECT A THIRD ARBITRATOR WHO SHALL BE QUALIFIED AS DEFINED ABOVE, AND SUCH THIRD ARBITRATOR SHALL BE THE SOLE ARBITRATOR TO HEAR AND DETERMINE THE DISPUTE. IF ANY PARTY HERETO FAILS TO NAME AN ARBITRATOR WITHIN THE TIME LIMIT PROVIDED IN THIS PARAGRAPH, THEN THE ARBITRATOR TIMELY NAMED BY THE OTHER PARTY SHALL HEAR AND DECIDE THE DISPUTE. IF THE ARBITRATION IS COMMENCED, THE PARTIES AGREE TO PERMIT DISCOVERY PROCEEDINGS OF THE TYPE PROVIDED BY THE CALIFORNIA CODE OF CIVIL PROCEDURE BOTH IN ADVANCE OF, AND DURING RECESSES OF, THE ARBITRATION HEARINGS. ALL FACTS AND OTHER INFORMATION RELATING TO ANY ARBITRATION ARISING UNDER THIS DECLARATION SHALL BE KEPT CONFIDENTIAL TO THE FULLEST

EXTENT PERMITTED BY LAW. THE DECISION OR THE ARBITRATOR(S) SHALL FOLLOW THE LAW, SHALL BE RENDERED WITHIN TEN (10) BUSINESS DAYS FOLLOWING THE CONCLUSION OF THE ARBITRATION, AND SHALL BE SET FORTH IN A WRITTEN OPINION STATING THE FINDINGS OF FACT OR THE ARBITRATOR(S) AND LEGAL AUTHORITIES THAT ARE THE BASIS OF THE DECISION. THE VENUE FOR ANY SUCH ARBITRATION SHALL BE THE COUNTY IN WHICH BENEFICIARY'S OFFICE AT THE ADDRESS SET FORTH HEREIN IS SITUATED. THE COSTS OF THE ARBITRATOR(S) SHALL BE SPLIT EQUALLY BY THE PARTIES BUT SHALL BE A RECOVERABLE COST FOR THE PARTY PREVAILING IN THE ARBITRATION.

4.115-3 Optional addition to 4.115-1: Judicial reference alternative

49.2 JUDICIAL REFERENCE. TO THE EXTENT A PREDISPUTE WAIVER OF THE RIGHT TO TRIAL BY JURY IS NOT ENFORCEABLE UNDER APPLICABLE LAW, ANY AND ALL DISPUTES, CONTROVERSIES OR CLAIMS ARISING OUT OF OR RELATING TO THIS DEED OF TRUST AND OTHER LOAN DOCUMENTS OR TRANSACTIONS CONTEMPLATED THEREBY, INCLUDING, WITHOUT LIMITATION, THE MAKING, PER FORMANCE, OR INTERPRETATION OF THIS DEED OF TRUST OR OTHER LOAN DOCUMENTS, SHALL BE HEARD BY A REFEREE AND RESOLVED BY JUDICIAL REFERENCE PURSUANT TO CALIFORNIA CODE OF CIVIL PROCEDURE §638. THE REFEREE SHALL BE AN ATTORNEY LICENSED TO PRACTICE LAW IN THE STATE OF CALIFORNIA AND EXPERIENCED AND QUALIFIED IN REAL ESTATE MATTERS OF THE TYPE CONTEMPLATED BY THIS DEED OF TRUST AND OTHER LOAN DOCUMENTS OR A RETIRED CALIFORNIA SUPERIOR OR APPELLATE COURT JUDGE. THE PARTIES SHALL NOT SEEK TO APPOINT A REFEREE THAT MAY BE DISQUALIFIED PURSUANT TO CALIFORNIA CODE OF CIVIL PROCEDURE §641 or §641.2 WITHOUT THE PRIOR WRITTEN CONSENT OF ALL PARTIES. IF THE PARTIES ARE UNABLE TO AGREE UPON A REFEREE WITHIN TEN (10) CALENDAR DAYS AFTER ONE PARTY SERVES A WRITTEN NOTICE OF INTENT FOR JUDICIAL REFERENCE ON THE OTHER PARTY OR PARTIES, THEN THE REFEREE WILL BE SELECTED BY THE COURT IN ACCORDANCE WITH CALIFORNIA CODE OF CIVIL PROCEDURE §640(b). ANY DECISION OF THE REFEREE SHALL BE ENTERED AS A JUDGMENT IN THE COURT IN ACCORDANCE WITH CALIFORNIA CODE OF CIVIL PROCEDURE §§644 and 645.

4.115-4 Optional addition to 4.115-1: Provisional remedies; foreclosure and injunctive relief

49.3 PROVISIONAL REMEDIES; FORECLOSURE AND INJUNCTIVE RELIEF. Nothing in Section 50.2, above, shall be deemed to apply to or limit the right of Lender to: (a) exercise self help remedies, (b) foreclose judicially or nonjudicially against any real or personal property collateral, or to exercise judicial or nonjudicial power of sale rights, (c) obtain from a court provisional or ancillary remedies (including, but not limited to, injunctive relief, a writ of possession, prejudgment attachment, a protective order or the appointment of a receiver), or (d) pursue rights against Borrower or any other party in a third party proceeding in any action brought against Lender (including, but not limited to, actions in bankruptcy court). Lender may exercise the rights set forth in the foregoing clauses (a) through (d), inclusive, before, during, or after the pendency of any proceeding referred to in Section 49.2, above. Neither the exercise of self help remedies nor the institution or maintenance of an action for foreclosure or provisional or ancillary remedies or the opposition to any such provisional remedies shall constitute a waiver of the right of any Borrower, Lender or any other party, including, but not limited to, the claimant in any such action, to require submission the dispute, claim or controversy occasioning resort to such remedies to any proceeding referred to in Section 49.2, above.

Comment: The jury trial waiver and the alternative dispute resolutions provisions are intentionally in boldface type and placed just before the borrower's signature to improve on the likelihood that it will be enforced, to the extent that it is enforceable. Predispute waivers of jury trial are not currently enforceable under California law (see *Grafton Partners LP v Superior Court* (2005) 36 C4th 944, 32 CR3d 5), unless coupled with an agreement to arbitrate disputes or for judicial reference of disputes. See §§4.58 and 3.103.

This form provides for arbitration and judicial reference as two alternative forms of dispute resolution from which a drafter may choose. The clauses in the form are fairly abbreviated by comparison to clauses used by institutional lenders, which tend to be tailored to specific policies and preferences of the lender concerning a variety of issues (*e.g.*, the forum and venue for arbitration or judicial reference, procedures for commencement of proceedings, selection and qualifications of an arbitrator or referee, the rules of arbitration to be used, severing of disputes with multiple parties some of which may not be subject to the alternative dispute resolution agreement, time lines for discovery and rendering of a decision and other procedural matters). For discussion of arbitration clauses, see Retail Leasing: Drafting and Negotiating the Lease, chap 36 (Cal CEB 2007); A Litigator's Guide to Effective Use of ADR in California, chaps 9-11 (Cal CEB 2005); Office Leasing: Drafting and Negotiating the Lease, chap 33 (Cal CEB 1996).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.116 R. Form: Signatures

§4.116 R. Form: Signatures

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4.116-1 Signatures

IN WITNESS WHEREOF, Borrower has executed and delivered this Deed of Trust as of the date first written above.

BORROWER TO SIGN DOCUMENT
EXACTLY AS NAME APPEARS

Date: _ _ _ _ _ _ _ _[*Name of limited liability company*]_ _**, a California limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: All parties having an interest in the real property the lender is receiving as security must sign the deed of trust. To be recorded, the signatures must be acknowledged. See §4.7. The form of a certificate of acknowledgment for all types of entities is in CC §1183.5 and in §4.117.

The decision in *Snukal v Flightways Mfg., Inc.* (2000) 23 C4th 754, 98 CR2d 1, discusses the requisite number of signatures by corporate officers for a written document to be binding on a corporation, at least based on the officers' apparent authority. The California Supreme Court concluded that under Corp C §313 "a contract is binding upon a corporation when an individual who in fact occupies the office of president, chief financial officer, *and* secretary of a corporation, executes a contract on behalf of the corporation, even when the contract expressly identifies the individual solely as its president." It is prudent practice to have a document signed by at least two officers unless the lender receives a corporate resolution authorizing signing by only one officer.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.117 S. Form: Acknowledgment

§4.117 S. Form: Acknowledgment

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4.117-1 Acknowledgment

Acknowledgment

State of California)
County of _ _[*name*]**_ _)**
)
_____)

On _ _[*date*]**_ _, before me, _ _**[*name and title of notary*]**_ _, personally appeared _ _**[*name(s) of borrower(s)*]**_ _ who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of notary*]__ [*Notary's seal*]

Comment: Civil Code §1189 requires this all-purpose acknowledgment after January 1, 1993. Nevertheless, any acknowledgment provided before January 1, 1993, that conforms to the applicable provisions of former CC §§1189, 1190, 1190.1, 1190a, 1191, and 1192, repealed in 1990, will have the same force and effect as if they had not been repealed. CC §1189(d).

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§4.118 T. Exhibit A

Exhibit A is a legal description of the mortgaged property. On description of mortgaged property, see §4.18.

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§4.119 U. Additional Provisions

Sections 4.120-4.122 contain additional provisions that may be added to the form deed of trust in the circumstances described in §§4.59-4.60.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.120 1. Form: Leasehold Lending Provisions

§4.120 1. Form: Leasehold Lending Provisions

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4.120-1 Leasehold lending provisions

__. Leasehold Provisions.

__.1. Leasehold Estate. If the security for this Deed of Trust is a leasehold estate demised by a lease (the Leasehold), this Deed of Trust shall be a lien on all present and future right, title, estate, and interest of Borrower in the Mortgaged Property and Improvements covered by the Leasehold and on all Mortgaged Property interests acquired by Borrower as a result of the exercise of any option in the Leasehold or as amended, in the same manner and to the same extent as if the Mortgaged Property encompassed in the Leasehold and option agreements had been held in fee by Borrower at the time of the execution of this Deed of Trust, and Borrower agrees not to amend, change, or modify its leasehold interest, or any of its terms, or to exercise any option to purchase, or agree to do so, without having obtained Lender's prior written consent. In a violation of this provision, Lender may, at its option, declare all sums secured by this Deed of Trust immediately due and payable. Consent to any amendment, change, or modification, or a waiver of the right to require such consent in one instance, shall not be a waiver of the right to require such consent at a subsequent time. The term "Mortgaged Property" as used in this Deed of Trust means such leasehold estate or any other present or future interest of Borrower in the Mortgaged Property whenever the context requires.

__.2. Compliance With Leasehold. In the event that the security for this Deed of Trust is a leasehold estate, Borrower covenants and agrees as follows: (a) to promptly and faithfully observe, perform, and comply with all Leasehold terms, covenants, and provisions on its part to be observed, performed, and complied with, at the times set forth in the Leasehold; (b) not to do, permit, suffer, or refrain from doing anything, as a result of which, there would be a default under or breach of any of the terms of the Leasehold; (c) not to cancel, surrender, modify, amend, or in any way alter or permit the alteration of any of the terms of the Leasehold; (d) to give Lender immediate notice of any default by anyone under the Leasehold and to promptly deliver to Lender copies of each notice of default and all other notices, communications, plans, specifications, and other similar instruments received or delivered by Borrower in this connection; (e) to furnish to Lender such information and evidence as Lender may reasonably require for Borrower's due observance, performance, and compliance with the Leasehold terms, covenants, and provisions; (f) that any default of the tenant under the Leasehold shall constitute an Event of Default under this Deed of Trust; and (g) to give immediate written notice to Lender of the commencement of any remedial proceedings under the Leasehold by any party to it and, if required by Lender, to permit Lender as Borrower's attorney-in-fact to control and act for Borrower in any such remedial proceedings. Borrower expressly transfers and assigns to Lender the benefit of all covenants in the Leasehold, whether or not such covenants run with the land, but Lender shall have no liability with respect to such covenants or any other covenants in the Leasehold.

__.3. Borrower's Warranties and Representations. With respect to the Leasehold, Borrower warrants and represents as follows: (a) the Leasehold is in full force and effect, unmodified by any writing or otherwise, except as specifically set forth in _ _[*e.g., Exhibit B*]_ _; (b) all rent, additional rent, and other charges reserved in the Leasehold have been paid to the extent they are payable to the date of this Deed of Trust; (c) Borrower enjoys the quiet and peaceful possession of the Mortgaged Property demised by the Leasehold; (d) Borrower is not in default under any Leasehold term and, to the best of its knowledge, there are no circumstances that, with the passage of time or the giving of notice or both, would constitute an Event of Default under the Leasehold; (e) to the best of Borrower's knowledge, the landlord under the Leasehold is not in default under any Leasehold term or provision the landlord is required to observe or perform.

__.4. Assignments to Lender. If Borrower files any petition or action for relief under any bankruptcy, reorganization, insolvency, moratorium law, or any other law or laws for the relief of or relating to debtors, on demand by Lender, Borrower covenants to transfer and assign to Lender its leasehold estate and the

Leasehold in lieu of rejection of the Leasehold by Borrower and covenants to assign to Lender its right to accept or reject the Leasehold and to apply for any extension of time within which to accept or reject the Leasehold. These assignments to Lender shall be automatic on Lender's demand. If Lender demands the assignment of the Leasehold under this Deed of Trust, Lender covenants to cure any defaults outstanding under the Leasehold after the Leasehold is assigned to Lender.

__.5. Default Under Leasehold. If Borrower defaults in performing any of its obligations under the Leasehold, including, without limitation, any default in the payment of rent and other charges and impositions made payable by the tenant under the Leasehold, then, in each and every case, Lender may, at its option and without notice, cause the default or defaults to be remedied and otherwise exercise any and all of the rights of Borrower under the Leasehold in the name of and on behalf of Borrower. Borrower shall, on demand, reimburse Lender for all advances made and expenses incurred by Lender in curing any such default (including, without limitation, reasonable Attorney Fees), together with interest computed at the rate provided for in the Note from the date that an advance is made or expense is incurred, to and including the date the same is paid. Lender shall have no duty to prevent the termination of the leasehold estate by the landlord. If the landlord terminates the leasehold estate, Lender shall have the right, at its option, to declare all sums secured by this Deed of Trust immediately due and payable and immediately bring an action on the Note, provided there is no other real property security for the Note.

__.6. Options. Borrower shall give Lender notice of its intention to exercise each and every option to extend the term of the Leasehold at least _ _[*e.g., 20 days*]_ _ but not more than _ _[*e.g., 60 days*]_ _ before expiration of the time to exercise such option under the Leasehold. If Borrower intends to extend the term of the Leasehold, it shall deliver to Lender, with the notice of such decision, a copy of the notice of extension delivered to the landlord under the Leasehold. If Borrower does not intend to extend the term of the Leasehold, Lender may, at its option, exercise the option to extend in the name and on behalf of Borrower.

__.7. No Merger/Attorney-in-Fact. It is hereby agreed that the fee title, the leasehold estate, and the subleasehold estate in the Mortgaged Property demised by the Leasehold shall not merge but shall be kept separate and distinct, despite the union of these estates in either the landlord under the Leasehold, Borrower, or a third party, whether by purchase or otherwise. If Borrower acquires the fee title or any other estate, title, or interest in the Mortgaged Property demised by the Leasehold or any part of it, the lien of this Deed of Trust shall attach to, cover, and be a lien on such acquired estate, title, or interest and it shall simultaneously be and become a part of the Mortgaged Property with the same force and effect as if specifically encumbered in this Deed of Trust. Borrower agrees to execute all instruments and documents that Lender may reasonably require to ratify, confirm, and further evidence Lender's lien on the acquired estate, title, or interest. Furthermore, Borrower appoints Lender as its true and lawful attorney-in-fact to execute and deliver all such instruments and documents in the name and on behalf of Borrower. This power, being coupled with an interest, shall be irrevocable as long as any amounts secured by this Deed of Trust remain unpaid.

__.8. Interests in Successor Leasehold. If the Leasehold is canceled or terminated, and if Lender or its nominee shall acquire an interest in any new lease of the Mortgaged Property demised by the Leasehold, Borrower shall have no right, title, or interest in or to the new lease or the leasehold estate created by such new lease.

__.9. Estoppel Certificate. Borrower shall use its best efforts to obtain and deliver to Lender, within _ _[*e.g., 20 days*]_ _ after written demand by Lender, an estoppel certificate from the landlord under the Leasehold setting forth (a) the name of the tenant under the Leasehold, (b) that the Leasehold has not been modified or, if it has been modified, the date of each modification (together with copies of each such modification), (c) the basic rent payable under the Leasehold, (d) the date to which the tenant paid all rental charges under the Leasehold, and (e) whether there are any alleged defaults of the tenant under the Leasehold and, if there are, setting forth their nature in reasonable detail.

__.10. Limitations on Lender's Liability Under Leasehold. Despite anything to the contrary in this Deed of Trust, this Deed of Trust shall not constitute an assignment of the Leasehold within the meaning of any provision of the Leasehold prohibiting its assignment, and Lender shall have no liability or obligation under the Leasehold because of its acceptance of this Deed of Trust. Lender shall be liable for the tenant's obligations arising under the Leasehold for only that period of time that Lender is in possession of the Mortgaged Property covered by the Leasehold or has acquired, by foreclosure or otherwise, and is holding all of Borrower's right, title, and interest in the Mortgaged Property covered by the Leasehold.

Comment: See discussion of leasehold lending provisions in §4.59. On subordination, nondisturbance, and attornment agreements, see Retail Leasing: Drafting and Negotiating the Lease, chap 44 (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease, chap 28 (Cal CEB 1996).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.121 2. Form: Partial Releases

§4.121 2. Form: Partial Releases

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.

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4.121-1 Partial releases

__. Partial Releases.

__. Grant of Partial Release. On payment to Lender of the agreed consideration for the release from the lien of this Deed of Trust of one or more lots as shown on a duly recorded Final Subdivision Map, and the performance of each and all of the conditions set forth in this paragraph, Lender agrees to cause the Trustee to prepare, execute, and grant a partial release and reconveyance of the lien of this Deed of Trust. When all of the following eight conditions have been performed and met, any one or more of the lots in the Mortgaged Property described in Exhibit A may be released and a Deed or Deeds of Reconveyance shall be requested from the Trustee for each lot sought by Borrower to be released. The conditions precedent are:

__.1. No Current Default. Borrower is not then in default under the Note or the Deed of Trust in the payment of principal, interest, loan costs, or fees, or in the performance of any of the terms, conditions, or covenants of the Note, Deed of Trust, _ _[*title of any construction loan agreement*]_ _, or any other Loan Document executed by Borrower in connection with the Loan;

__.2. No Future Default. No event has occurred that after notice, passage of time, or both, shall constitute a default;

__.3. Remaining Property Secured. All Mortgaged Property and Personalty providing security for the payment of the Note and other Indebtedness, loan fees and costs described in this Deed of Trust, other than portions of the Mortgaged Property security, if any, previously reconveyed under this paragraph and portions of the Mortgaged Property that may now be released as provided in this paragraph, is still and shall remain subject to the lien of this Deed of Trust; despite the foregoing, no portion of the Mortgaged Property shall be released that will prevent Lender's means of ingress and egress to the Mortgaged Property not yet released unless there is provided to Lender an easement of access to unreleased Mortgaged Property, or Mortgaged Property to be released contains streets or roads dedicated to the public use that would allow access by Lender to Mortgaged Property not yet released;

__.4. Lender's Fees and Costs. Borrower shall have paid all costs, trustee's fees, Attorney Fees if incurred by Lender, and expenses of Lender incurred in connection with any reconveyance;

__.5. Title Endorsements. Lender shall receive, at Borrower's expense, a CLTA Endorsement No. 111 to its title insurance policy obtained on the making of the loan secured by this Deed of Trust, as well as any other title endorsements reasonably required by Lender;

__.6. Other Documents. Borrower causes to be executed and recorded such reciprocal easement agreement, declaration of covenants, conditions, and restrictions, or other agreement the effect of which would be to burden the portion of the Mortgaged Property sought to be reconveyed with rights of access, ingress, and egress, among other things, in favor of the balance of the Mortgaged Property, as Lender shall require, in such form and content as shall be satisfactory to Lender; and the portion of the Mortgaged Property to be reconveyed and the remainder of the Mortgaged Property shall each be "legal lots" under the Subdivision Map Act of the State of California and applicable local ordinances promulgated under that Act;

__.7. Payment of Consideration. The consideration for the partial release and reconveyance of lots in the amount or amounts specified in _ _[*e.g., Exhibit C*]_ _ shall have been paid to Lender; and

__.8. Original Purchase Agreement. Borrower shall have furnished to Lender a copy of the original executed purchase agreement and all exhibits to it.

Comment: See discussion of partial release clauses in §4.60. On Subdivision Map Act generally, see California Subdivision Map Act and the Development Process (2d ed Cal CEB 2001).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/4 The Deed of Trust/§4.122 3. Form: Third Party Trustor/Suretyship Waivers

§4.122 3. Form: Third Party Trustor/Suretyship Waivers

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.62-4.122.

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4.122-1 Third party trustor/suretyship waivers

__. Third Party Trustor/Suretyship Waivers. In recognition of the fact that Borrower, not Trustor, is the maker of the Note, Trustor agrees to the following provisions:

__.1. Authorization to Act. Trustor authorizes Lender at any time, in its discretion without notice or demand and without affecting the indebtedness and liabilities of Trustor, to:

__.1.1. Enter into agreements with Borrower and, in accordance with such agreements, renew, extend, amend, waive, restructure, refinance, release, accelerate, or otherwise change the time for payment of, or otherwise change the terms of the Note or the Indebtedness, including (a) increase or decrease in the Indebtedness or the rate of interest on the Note or the Indebtedness; and (b) any amendment of the Note or Loan Documents or the Indebtedness, to permit Lender to extend further or additional accommodations to Borrower in any form, including credit by way of loan, lease, sale or purchase of assets, guaranty, or otherwise, which shall then be and become subject to the Indebtedness;

__.1.2. Accept new or additional documents, instruments, or agreements relative to the Note or the Indebtedness;

__.1.3. Consent to the change, restructure, or termination of the individual, partnership, or corporate structure or existence of Borrower, Trustor, or an affiliate of Borrower or Trustor and correspondingly restructure the Indebtedness;

__.1.4. Accept partial payments on the Note or the Indebtedness;

__.1.5. Take and hold collateral or additional guaranties for the Note or the Indebtedness and amend, alter, exchange, substitute, transfer, enforce, waive, subordinate, terminate, or release any such collateral or guaranties;

__.1.6. Apply any collateral, and direct the order and manner of sale as Lender in its sole and absolute discretion may determine;

__.1.7. Settle, release on terms satisfactory to Lender or by operation of law or otherwise, compound, compromise, collect, or otherwise liquidate the Note or the Indebtedness and/or the collateral or any guaranty therefor in any manner, whether in liquidation, reorganization, receivership, bankruptcy, or otherwise;

__.1.8. Release Borrower or any other party for all or any part of the Note or the Indebtedness; or

__.1.9. Assign the Note, and with it the Deed of Trust, in whole or in part.

__.2. Independent Obligations. Trustor's obligations under the Deed of Trust are independent of those of any other person. Lender may bring a separate action against Trustor, and Trustor waives any right to require Lender to proceed against Borrower or any other person, firm, or corporation or to proceed against or exhaust any other security held by it at any time or to pursue any other remedy in its powers, and Trustor agrees that Lender shall not be obligated to resort to any other security, including security given by Borrower, with any priority, in any particular order, or at all, even if such action destroys, alters, or otherwise impairs Trustor's subrogation rights or the Trustor's right to proceed against Borrower for reimbursement, or both.

__.3. Suretyship Waiver. Trustor waives and agrees not to assert or take advantage of:

__.3.1. Any right to require Lender to proceed against Borrower or any other person or any security now or later held by Lender or to pursue any other remedy whatsoever, including any such right or any other right set forth in California Civil Code §2845 or §2850;

__.3.2. Any defense based on any legal disability of Borrower or any other person, or any discharge or limitation of the liability of Borrower or any other person to Lender, or any restraint or stay applicable to actions against Borrower or any other person, whether such disability, discharge, limitation, restraint, or stay is consensual, or by order of a court or other governmental authority, or arising by operation of law or any liquidation, reorganization, receivership, bankruptcy, insolvency, debtor-relief proceeding, or from any other use;

__.3.3. Presentment, demand, protest, setoffs, counterclaims, and notice of any kind;

__.3.4. Any defense based on the modification, renewal, extension, or other alteration of the Indebtedness;

__.3.5. Any defense based on Lender's negligence, including the failure to record an interest under the Deed of Trust, the failure to protect any security interest, or the failure to file a claim in any bankruptcy of Borrower, Trustor, or of any other person;

__.3.6. Any defense based on a statute of limitations to the fullest extent permitted by law and any defense based on Lender's delay in enforcing the Deed of Trust;

__.3.7. All rights of subrogation, reimbursement, indemnity, contribution, any other rights that may become available to Trustor under California Civil Code §§2787-2856, inclusive, all rights to enforce any remedy that Lender may have against Borrower or any other person, and all rights to participate in any security held by Lender for the Indebtedness, including any such right or any other right set forth in California Civil Code §1845, §2848, or §2849, until the Indebtedness has been performed in full, and any defense based on the impairment of any subrogation rights that Trustor may have;

__.3.8. Any defense based on or arising from any defense that Borrower may have to the performance of any part of the Indebtedness;

__.3.9. Any defense to recovery by Lender of a deficiency after a nonjudicial sale of real or personal property, any defense based on the unavailability to Lender of recovery of a deficiency judgment after nonjudicial sale of real or personal property, and any defense based on or arising from California Code of Civil Procedure §580a, §580b, §580d, or §726 (including any fair value limitations under §726 of that Code) or based on or arising from Division 9 or any other applicable division of the California Commercial Code;

_.3.10. Any defense based on the death, incapacity, lack of authority, or termination of existence or revocation by any person(s) or entity(ies), or the substitution of any party to this Deed of Trust;

_.3.11. Any defense based on or related to Trustor's lack of knowledge of Borrower's financial condition;

_.3.12. Any defense based on California Civil Code §2809; and

_.3.13. Any defense or right based on the acceptance by Lender or an affiliate of Lender of a deed in lieu of foreclosure, without extinguishing the debt, even if such acceptance destroys, alters, or otherwise impairs subrogation rights of Trustor, or the right of Trustor to proceed against Borrower for reimbursement, or both.

__.4. Trustor's Knowledge of Borrower. Trustor, by execution of this Deed of Trust, represents to Lender that the relationship between Trustor and Borrower is such that Trustor has access to all relevant facts and information on the Indebtedness and on Borrower, and that Lender can rely on Trustor's having such access. Trustor waives and agrees not to assert any duty of Lender to disclose to Trustor any facts that it may now know or later learn about Borrower, regardless of whether Lender has reason to believe that any such facts materially increase the risk beyond that which Trustor intends to assume, has reason to believe that such facts are unknown to Trustor, or has a reasonable opportunity to communicate such facts to Trustor. Trustor is fully responsible for being and keeping informed of Borrower's financial condition and all circumstances bearing on the risk of nonpayment of any Indebtedness secured by this Deed of Trust.

__.5. Waiver of Real Property Security Defenses. Trustor waives all rights and defenses that Trustor may have because Borrower's debt is secured by real property. This means, among other things, that (a) Lender may collect from Trustor without first foreclosing on any real or personal property collateral pledged by Borrower; and (b) if Lender forecloses on any real property collateral pledged by Borrower, then (i) the amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price, and (ii) Lender may collect from Trustor even if Lender, by foreclosing on the real property collateral, has destroyed any right Trustor may have to collect from Borrower. This is an unconditional and irrevocable waiver of any rights and defenses Trustor may have because Borrower's debt is secured by real property. These rights and defenses include any rights or defenses based on California Code of Civil Procedure §580a, §580b, §580d, or §726.

__.6. Choice of Remedy. On a default under the Indebtedness, or any part of it, Lender may elect to foreclose nonjudicially or judicially against any real or personal property security it holds for the Indebtedness or any part of it, or exercise any other remedy. No such action by Lender shall release or limit the liability of Trustor, even if the effect of that action is to deprive Trustor of the right to collect reimbursement from Borrower or any other person for any sums paid to Lender, or to obtain reimbursement by means of any security held by Lender for the Indebtedness, or to impair any subrogation right Trustor may have.

__.7. Waiver of Notice. Trustor waives demand, protest, and notice of any kind, including, without limiting the generality of the foregoing, notice of the existence, creation, or incurring of new or additional indebtedness, or of any action or nonaction by Borrower, Lender, any endorser, any creditor of Borrower or Trustor under this or any other instrument, or any other person whatsoever, in connection with any Indebtedness or evidence of Indebtedness held by Lender as collateral or in connection with any Indebtedness secured by this Deed of Trust.

__.8. Application of Payments. With or without notice to Trustor, Lender may, in its sole and absolute discretion, at any time and from time to time, in such manner and on such terms as it considers best: (a) apply any and all payments or recoveries from Borrower, from Trustor, from any trustor or endorser, or realized from any security, in such manner, order, and priority as Lender elects, to any Indebtedness of Borrower to Lender whether or not such Indebtedness is secured by this Deed of Trust or is otherwise secured or is due at the time of such application; and (b) refund to Borrower any payment received by Lender on any Indebtedness secured by this Deed of Trust, and payment of the amount refunded shall be fully secured by this Deed of Trust.

__.9. No Recourse Against Lender. No exercise or nonexercise by Lender of any right hereby or otherwise given it, no dealing by Lender with Borrower or any other person, and no change, impairment, or suspension of any right or remedy of Lender, shall in any way affect any obligation of Trustor under this Deed of Trust or give Trustor any recourse against Lender.

Comment: These provisions should be added when the trustor is not the maker of the note. See §4.3.

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5

The Assignment of Rents

C. Gregg Ankenman

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I. INTRODUCTION

§5.1 A. Assignment Requires Agreement

Before a foreclosure sale on California real property, a secured lender is not entitled to possession of, or to rents payable by tenants on, the property securing the loan unless borrower and lender have made a special agreement on the right to possession and rents. *Title Guar. & Trust Co. v Monson* (1938) 11 C2d 621, 81 P2d 944; *Freeman v Campbell* (1895) 109 C 360, 42 P 35. This is true regardless of whether the security instrument encumbering the property is a deed of trust or a mortgage. *Snyder v Western Loan & Bldg. Co.* (1934) 1 C2d 697, 37 P2d 86. (For convenience and brevity, the term "deed of trust," as used in this chapter, refers to both mortgages and deeds of trust. On the differences between them, see §4.1 and California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 1-3 (4th ed Cal CEB 2009).)

The special agreements that confer on the lender the rights to possession of, and rents accruing from, the encumbered property are commonly referred to as "assignments of lessor's interest in leases," "rents and profits clauses," or "assignments of rents" provisions. These agreements (collectively referred to in this chapter as "assignments of rents" or "assignments") can be incorporated into the deed of trust or they can be in an independent contract between borrower and lender.

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§5.2 B. Abolishment of Absolute Assignment

Although most institutional lenders nationwide use a separate agreement for the assignment of rents, other lenders are generally better advised to incorporate the assignment into the deed of trust without making a separate agreement. Historically, institutional lenders' use of separate agreements for assignments of rents was based, at least in part, on their desire to reinforce the concept that the assignment is absolute, not merely part of the security package. Typical assignment language in the past would absolutely assign the rents to the creditor, but it would give back a license to the debtor to collect the rents with the license terminating on a default. In 1997, changes to CC §2938 eliminated absolute assignments of rents in California regardless of the contractual language (see §§5.3-5.9). For additional discussion of the historic development of assignments of rents and the laws applicable to older assignments, see California Mortgages, Deeds of Trust, and Foreclosure Litigation §§6.19-6.24 (4th ed Cal CEB 2009).

There is now generally no substantial benefit in California to having a separate assignment of rents agreement in loans secured by California property. Nonetheless, because many other states do allow absolute assignment, the use of national forms by institutional lenders (particularly in securitized loans, discussed in chap 10; see also §§1.18, 1.33, 1.90-1.107) is likely to perpetuate both separate assignment agreements and the use of "absolute" assignment language. Borrowers who entered into transactions after 1996 need not be concerned if a lender's form states that an assignment of rents is absolute. Current CC §2938 provides that all assignments of rents made in connection with an obligation secured by real property are assignments as additional security regardless of any contrary designation by the parties. See Mortgage Deed of Trust Foreclosure §§6.25-6.30. See also §§5.3-5.6.

The discussion of assignments of rents in this chapter concerns the assignments as they are used in real property financing transactions under current law. Consequently, it should be kept in mind that assignments of rents are just one part of security "packages," which usually include a deed of trust (see chap 4), a promissory note (see chap 3), a personal property security agreement and a UCC-1 financing statement (see chap 7), and, often, a guaranty (see chap 6).

The assignment of rents form in §§5.10-5.34 may be used in conjunction with a real property secured loan. References in the assignment to the "note" and the "deed of trust" refer to the promissory note and the deed of trust executed in conjunction with the assignment. This assignment assumes that it will be used with a note and deed of trust based on the forms in chaps 3-4. If not used with these forms, certain provisions (especially definitions of terms incorporated by reference to the deed of trust) may need to be adjusted.

For an excellent discussion of California law (past and current) on assignments of rents, see Williams, Hindmarsh, O'Neill & Waldman, *Assignment of Rents—The Next Generation*, 15 Cal Real Prop J 29 (1997). See also *Muñoz, A New Beginning: Major Changes in the Law on Rents and Profits Liens*, 19 CEB Real Prop L Rep 176 (Aug. 1996). See generally Mortgage Deed of Trust Foreclosure, chap 6.

NOTE: California was the first state to adopt this type of comprehensive assignment-of-rents statute. Following California's lead, in 2003 the National Conference of Commissioners on Uniform State Laws (NCCUSL) appointed a drafting committee to prepare a Uniform Assignment of Rents Act (UARA). In July 2005, the NCCUSL approved the UARA and recommended its enactment in the various states. The UARA follows existing California law to a large extent, equating recording and perfection, and rejecting the notion of an absolute assignment of rents. For an overview, see Freyermuth, *Modernizing Security in Rents: The New Uniform Assignment of Rents Act*, 71 Mo L Rev (Winter 2006).

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II. LEGAL AND PRACTICAL CONSIDERATIONS

§5.3 A. Revised CC §2938

In 1996 the legislature repealed the old statutes on assignments of rents and enacted another version of CC §2938, which applies to all assignments of rents entered into after 1996. Stats 1996, ch 49. The legislation restates and significantly amends California law on assignment of rents, issues, and profits (collectively "rents"). The current CC §2938 eliminates the distinctions among assignments denoted as "absolute," "absolute conditional on default," "additional security," or otherwise (see §5.2). It provides that all assignments, whether in a deed of trust or in a separate document, are perfected on recordation, and it establishes detailed procedures for their enforcement. It also greatly clarifies and simplifies the requirements for creation, perfection, enforcement, and administration of assignments of rents (see §§5.4-5.9).

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§5.4 B. Creation and Perfection

Under CC §2938(a), the assignor's execution and delivery of a written assignment of rents creates a "present security interest in existing and future leases, rents, issues, or profits" of the encumbered real property. All assignments made in connection with an obligation secured by real property and created on or after January 1, 1997, are deemed to create security interests in rents as additional security for the secured obligations. CC §2938(a).

The lien created by an assignment of rents is deemed fully perfected on recordation of the assignment in the county where the real property is located. CC §2938(b). This is true whether the assignment is recorded as a separate document or as part of the deed of trust. Section 2938(b) makes it clear that perfection is not diminished by any provision of the assignment or of law that might preclude or defer enforcement of the assignee's rights, including deferral, unless the assignor defaults, the assignee obtains possession of the property, or the assignee obtains the appointment of a receiver.

Under prior law, the issue of perfecting an assignment of rents was a source of considerable confusion. Now it is clear that recordation *is* perfection for establishing priority between competing lien claimants and for resolving bankruptcy avoidance powers. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 6 (4th ed Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.5 C. Enforcement

§5.5 C. Enforcement

A properly perfected assignment of rents does not give the lender the right to specific rents (in a nonbankruptcy context at least) unless the borrower defaults and the lender properly exercises its enforcement rights. After a default, the lender has four means of enforcing its lien on rents under CC §2938(c):

- Appointing a receiver;
- Obtaining possession of the rents;
- Delivering to one or more of the tenants a written demand (in a specified form) to turn over the rents, with copies to the assignor and the holders of any other recorded junior interests in the rents; or
- Delivering to the assignor (borrower) a written demand for the rents, with a copy to holders of other recorded junior interests in the rents.

These procedures are similar to those available under Com C §9607 for a secured creditor with a lien on accounts receivable. A lender may use any one or more of these remedies, which are incorporated into the form in §5.18. For a comprehensive discussion of these remedies, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 6 (4th ed Cal CEB 2009).

Grounds for the appointment of a receiver to enforce an assignment of rents are set forth in CCP §564(b)(10)-(11). In conjunction with the overhaul of the assignments of rents statute (see §§5.3-5.4), the legislature added CCP §564(b)(11) to specifically provide for the appointment of a receiver under CC §2938. The receiver's appointment is usually ancillary to a judicial foreclosure action or to an action pending on a complaint to specifically enforce the assignment. See Mortgage Deed of Trust Foreclosure §§3.5, 3.55, 6.34-6.48. See CCP §§564-570 and Cal Rules of Ct 3.1175-3.1184 for procedural aspects of a receivership. In many jurisdictions, a small number of persons (who also frequently serve as trustees in bankruptcy) receive most of the appointments as receivers. Many superior courts also maintain receiver lists.

The language of the form of demand on tenants is prescribed by CC §2938(k). For a statutory form and discussion of tracing of rents and competing claims of multiple assignees, see Mortgage Deed of Trust Foreclosure §§6.107-6.110. For discussion of bankruptcy considerations in enforcing assignments, see Mortgage Deed of Trust Foreclosure, chaps 7, 11.

NOTE: Civil Code §2938 expressly states that none of the authorized enforcement actions violates CCP §726, makes the assignor a "mortgagee in possession," or otherwise bars a deficiency judgment or causes a loss of security.

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§5.6 D. Right to Rents

The assignor (borrower) is entitled to collect and retain rents until the assignee (lender) undertakes an authorized enforcement action following a default by the assignor (see §5.18). Many lenders' forms of assignment still include the concept of a revocable license given to the assignor to collect rents. This is very much tied in with the idea of an absolute assignment. Although the use of either out-of-date forms or national forms may perpetuate these terms and concepts in lender's forms, under CC §2938 even assignments termed "absolute" are assignments as additional security, and the assignor has a clear right to rents unless a default occurs and enforcement is undertaken (see §§5.3-5.6). See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 6 (4th ed Cal CEB 2009).

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§5.7 E. Application of Rent

After properly taking an enforcement action, the assignee (lender) is entitled to receive accrued but uncollected rent as well as rents accruing from and after the enforcement action. CC §2938(c). For discussion of the tracing of funds, see California Mortgages, Deeds of Trust, and Foreclosure Litigation §6.64 (4th ed Cal CEB 2009). Most lenders' form assignments, including the form in this chapter, give the lender broad discretion in applying the rent collected (see §5.20). Although this is good practice from the lender's viewpoint, lenders and their counsel should keep in mind that, under CC §2938(g)(1), the assignor or any other assignee may demand that the collecting assignee first apply the funds to reasonable costs of property maintenance, including taxes, insurance, and compliance with building and housing codes. Moreover, the funds applied to reduce the secured obligations must first be applied to cure any existing defaults. CC §2938(c), (e). Doing so does not expose the self-help lender to liability as a mortgagee in possession. CC §2938(g)(2). For further discussion, see Mortgage Deed of Trust Foreclosure §§6.3-6.8, 6.49.

PRACTICE TIP: Despite the requirements imposed on the lender to apply collected rents when the borrower makes a demand under CC §2938(g), it is still advisable when drafting the assignment for lender's counsel to give the lender discretion in applying the rents. Unless the borrower demands that rents be applied to reasonable property maintenance costs, the lender can apply the rents as allowed in the controlling assignment agreement. Without a discretionary or other provision allowing disposition of rents, they must be applied to the debt. CC §2938(c).

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§5.8 F. Lender Approval of Leases

In most loan transactions involving commercial property, the lender relies on the stream of rental income to enable the borrower to make loan payments. As a result, lenders are legitimately concerned about maintaining control and approval rights over leases. Many lenders' forms, therefore, contain broad lender approval requirements on entering into new leases, as well as modifying, extending, or terminating existing leases (see, *e.g.,* paragraph 2.9 in §5.13).

Borrowers, however, are concerned about maintaining sufficient autonomy and flexibility to manage their properties and negotiate effectively with tenants in the marketplace (see negotiating points in Comment in §5.13). Borrowers argue, often successfully, that at least for lease transactions meeting certain preagreed parameters, such as leases made in the ordinary course of business, lender approval should not be required. Although each situation is unique, standard concepts are (1) using preapproved lease forms, (2) exempting from the approval process leases that meet certain standards for term, premises size, tenant quality, and rent amount, and (3) special treatment of anchor-tenant leases. A sample negotiated provision is included in the form assignment as paragraph 2.10 in §5.14.

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§5.9 G. Cash Management Provisions

Lenders are concerned that the assignor (borrower) operate, manage, and maintain the property in an appropriate manner, effectively administer leases, and meet its obligations relating to the property. Many assignment forms include specific covenants to address these concerns. As with leasing, borrowers should attempt to negotiate appropriate autonomy and flexibility.

In the majority of transactions, particularly those involving national lenders or securitized loans (see chap 10; see also §§1.18, 1.33, 1.90-1.107), lenders will require provisions, commonly known as "lock box provisions," to control the collection and disbursement of rental funds and the management of the property generally. See §§1.45, 1.98. Lock box provisions are often tied into separate cash management and disbursement agreements. The basic idea is that during applicable periods commonly known as "sweep" periods, rents are paid directly into an account or accounts from which disbursements must be made strictly in accordance with pre-set instructions. Generally, the goal of such instructions is to ensure proper debt service as well as payment of other obligations relating to the property and to establish reserves for repairs and re-leasing. If not routinely set up at the start of the loan term, triggering events for sweep periods may include the falling of the debt service ratio below a set amount or the occurrence of an event of default (particularly a monetary default).

The basic lock box arrangement is generally not negotiable, but borrowers can often successfully argue for some relief such as limits on reserves and the right to receive all excess funds.

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III. FORM FOR ASSIGNMENT OF BORROWER'S INTEREST IN LEASES

§5.10 A. Form: Recording Format

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.10-5.34.

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5.10-1 Recording format

Recording Requested by)
After Recording Return to) **(Space above this line for**
) recorder's use)
) _____
_____)

Attn: _____

Loan No.: _____

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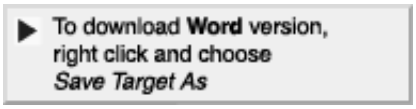
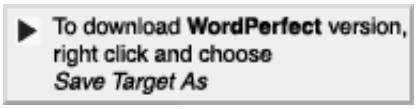
§5.11 B. Form: Title; Opening Clauses; Identification of Parties and Loan Documents

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.10-5.34.





5.11-1 Title; opening clauses; identification of parties and loan documents

ASSIGNMENT OF LEASES AND RENTS

This Assignment of Leases and Rents (Assignment) is made as of _ _[*date*]_ _, by _ _[*name*]_ _, a California limited liability company (Borrower), to _ _[*name*]_ _, _ _[*entity*]_ _, a national bank (Lender). This Assignment is made in connection with that certain Deed of Trust, Assignment of Leases and Rents, Fixture Filing and Security Agreement, and Request for Notices (collectively, Deed of Trust) of _ _[*date*]_ _, among Borrower, as trustor; Lender, as beneficiary; and _ _[*name*]_ _, a California corporation, as trustee, and in connection with the Loan and the other Loan Documents as defined in the Deed of Trust. Unless otherwise specified, all defined terms with initial capital letters used in this Assignment shall have the meanings set forth in the Deed of Trust.

Comment: This form was designed to be used with the note and deed of trust forms in chaps 3-4. Because it will be necessary to refer to the parties to an assignment repeatedly throughout the assignment document, it is helpful to identify the parties at the beginning of the document and to give each party a brief designation to avoid cumbersome references throughout. In many preprinted form assignments, "assignee" and "assignor" are used to indicate the parties; to minimize confusion between those designations, this form uses "Lender" and "Borrower," respectively. For further discussion of the need for this form, see §5.2.

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§5.12 C. Form: Assigning Clause

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.10-5.34.

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5.12-1 Assigning clause

1. Assignment. For the purpose of securing the full and timely payment of the Indebtedness and the full and timely performance and discharge of the Obligations, Borrower does hereby irrevocably GRANT, BARGAIN, TRANSFER, CONVEY, and ASSIGN to Lender the Leases and Rents, to be effective to create a present security interest in existing and future Leases and Rents of the Mortgaged Property under California Civil Code §2938. The Mortgaged Property as defined in the Deed of Trust includes without limitation the real property described in the attached Exhibit A.

Comment: Lender's counsel should ensure that the secured interest in the assignment covers existing and future leases, rents, issues, and profits of the mortgaged property. Doing so is important to allow the lender to take advantage of the proceeds doctrine in the current CC §2938(f), which applies after the creditor enforces the assignment by demand (under CC §2938(c)(3)-(4)). The doctrine provides that, if the debtor collects rents subject to an assignment before the creditor makes its demand, the creditor (a) may sue to have the rents immediately turned over to it (without violating the one-action rule) and (b) has priority over any other creditors who hold unenforced security interests in proceeds, as long as the rent proceeds are identifiable. The definitions of "Leases" and "Rents" incorporated from the form deed of trust in chap 4 (see §4.66) accomplish this. For further discussion of proceeds and tracing and priority issues on rents collected under CC §2938(c), see California Mortgages, Deeds of Trust, and Foreclosure Litigation §§6.54-6.56 (4th ed Cal CEB 2009). Note that "Mortgaged Property," as defined in the form deed of trust, includes the "Land, Improvements, Fixtures, Personalty, Leases and Rents," together with all right, title, and interest that borrower has or may in the future acquire in the mortgaged property. See §§4.18 and 4.66.

Leases of portions of the premises subject to the assignment will often be terminating and originating several times throughout the loan term because assignment of rents clauses are used in conjunction with long-term financing. It is thus necessary to obtain an assignment of any leases that may be entered into after the initial execution of the assignment, as well as any that existed when the assignment was executed. This form is designed to cover subsequently executed leases without requiring further execution of amendments or addendums to the assignment.

On Exhibit A, see §5.34.

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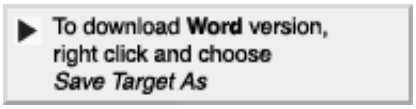
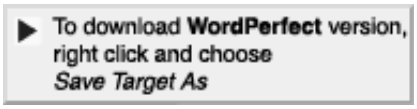
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.13 D. Form: Borrower's Representations, Warranties, and Covenants

§5.13 D. Form: Borrower's Representations, Warranties, and Covenants

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.10-5.34.





5.13-1 Borrower's representations, warranties, and covenants

2. REPRESENTATIONS, WARRANTIES, AND COVENANTS OF BORROWER. TO MAINTAIN AND PROTECT THE SECURITY OF THIS ASSIGNMENT, TO SECURE FULL AND TIMELY PERFORMANCE BY BORROWER OF EACH AND EVERY OBLIGATION, COVENANT, AND AGREEMENT OF BORROWER UNDER THE LOAN DOCUMENTS, AND AS ADDITIONAL CONSIDERATION FOR THE INDEBTEDNESS AND OBLIGATIONS EVIDENCED BY THE LOAN DOCUMENTS, BORROWER HEREBY REPRESENTS, WARRANTS, AND COVENANTS AS FOLLOWS:

2.1. Borrower's Interest. Borrower is the sole owner of its entire interest as lessor under each Lease, has not executed any other assignment of any of the Leases or Rents, and has not done and shall not do anything that might prevent Lender from fully exercising its rights under this Assignment.

2.2. Leases Valid. The Leases are valid and enforceable in accordance with their terms and have not been altered, modified, amended, terminated, or renewed, nor have any of the terms and conditions of the Leases been waived in any manner except as approved in writing by Lender.

2.3. Only Occupancy Lease. No Leases for occupancy of space within the Mortgaged Property have been or shall be entered into except for actual occupancy by the Tenants under such Leases. "Tenants" shall mean all tenants, lessees, subtenants, licensees, occupants, or similar parties to Leases for occupancy of space within the Mortgaged Property and their successors and assigns.

2.4. No Defaults. No defaults presently exist under any of the Leases, and no state of facts exists that, with the giving of notice, lapse of time, or both, would constitute a default under any of the Leases; Borrower shall fulfill or perform each and every condition and covenant of each of the Leases by Borrower to be fulfilled or performed, give prompt notice to Lender of any notice of default either given or received by Borrower under any of the Leases, together with a complete copy of any such notice; and Borrower shall, at the sole cost and expense of Borrower, enforce, short of termination of any Lease, the performance or observance of all covenants and conditions of all such Leases by the Tenant(s) to be performed or observed.

2.5. No Advance Rents. Borrower has not collected or accepted, and shall not collect or accept, payment of Rents under any of the Leases more than _ _[*e.g., one month*]_ _ in advance.

2.6. No Other Assignments. Borrower shall not, without Lender's prior written consent, execute any other assignment of the Leases or Rents.

2.7. No Merger. Each Lease shall remain in full force and effect regardless of any merger under the Lease of the interests of any parties to it.

2.8. Statements. Borrower shall furnish to Lender, within _ _[*e.g., 30 days*]_ _ after Lender's request to do so, a written statement containing the names of all Tenants of the Mortgaged Property, the terms of their respective Leases, the designation of the spaces occupied, and the Rents paid.

2.9. Leases. Borrower shall not, without Lender's prior written consent, (a) execute any future Leases of any portion of the Mortgaged Property; (b) terminate or consent to the cancellation or surrender of any Leases of the Mortgaged Property or of any part of it, having an unexpired term of _ _[*e.g., 6 months*]_ _ or more; (c) modify, alter, or amend any Leases, including, without limitation, shortening any unexpired term, decreasing the amount of the Rents payable, altering the structure of buildings or improvements within the Mortgaged

Property or changing its use; (d) accept prepayments more than _ _[*e.g., 30 days*]_ _ before the due date of any installments of the Rents to become due and payable under any Leases; (e) accept any security deposit equal to more than _ _[*e.g., 2 months*]_ _ of any such installments of Rents; (f) consent to an assignment or subletting of the Mortgaged Property, in whole or in part, except as required under the Leases as approved by Lender; (g) consent to any settlement or compromise conditioned on acceptance of less than full payment of the amounts due in connection with any Lease whether under bankruptcy or applicable nonbankruptcy law; or (h) cause or permit any Leases to be subordinated to any lien on the Mortgaged Property, except for the lien of the Deed of Trust.

All Leases entered into by Borrower after the date of this Assignment shall be subject to the prior review and approval of Lender and shall be in form and content acceptable to Lender. Each Lease shall specifically provide, inter alia, that such Lease is subordinate to the lien of the Deed of Trust and this Assignment, that the Tenants attorn to Lender (and Borrower hereby consents to any such attornment), such attornment to be effective on Lender's acquisition of title to the Mortgaged Property; that the Tenants agree to execute such further evidence of attornment as Lender may from time to time request; that the attornment of the Tenants shall not be terminated by foreclosure; and that Lender at its option may accept or reject such attornment. If Borrower becomes aware that any of the Tenants proposes to do, or is doing, any act that may give rise to set-off rights against Rents, Borrower shall immediately (a) take such measures as shall be reasonably calculated to prevent the accrual of any such rights of set-off; (b) notify Lender of all measures so taken and of the amount of any setoffs claimed by such Tenants; and (c) within _ _[*e.g., 10 days*]_ _ after the accrual of any set-off rights against Rents, reimburse Tenants who have acquired such rights, in full, or take such other measures as shall effectively discharge such setoffs and ensure that Rents due thereafter shall continue to be payable without claims of setoff or deduction.

If any Lease is terminated before its stated term has expired, all payments made by the Tenants in conjunction with such termination (including, but not limited to, voluntary buyout or termination payments, or payments made by or on the Tenants' behalf, incident to the Tenants' rejecting the Lease in accordance with the federal Bankruptcy Code (or similar state creditors' rights laws)), shall be made directly to Lender, and Borrower shall have no right to any such payments. Lender shall, in its reasonable discretion, apply such payments toward the Indebtedness due under the Note or toward the Mortgaged Property, including maintenance and repairs, payment of insurance premiums and taxes, and prevention of waste.

Comment: Paragraphs 2.1-2.9 contain a fairly typical set of requested representations and warranties. From the lender's viewpoint, they serve two important purposes: (1) They provide the lender with a level of assurance of the current and future value of the mortgaged property, and (2) they enhance the marketability of the loan on the secondary market by complying with standards for loan securitization. On standards for loan securitization, see chap 10; see also §§1.94-1.107.

In Paragraphs 2.1-2.5, the borrower makes several representations and warranties that directly relate to the value of the leases and the rents derived from them. The focus of these clauses is the status of the leases and rents at the time the assignment is made. Paragraphs 2.4-2.9 set forth several covenants regarding the borrower's conduct after the initial execution of the assignment. All covenants remain in effect, as does the assignment itself. A breach of any representation, warranty, or covenant allows the lender to resort to remedies under the assignment or other loan documents, as well as remedies at law or in equity.

Although the importance of each representation may vary among transactions, borrower's counsel should carefully review the requested representations and attempt to negotiate qualifications as appropriate. For example, a borrower may be able to qualify or eliminate the enforceability component of Paragraph 2.2. The representation of no lease defaults in Paragraph 2.4 is often replaced with a representation that no notices of default have been given or qualified by a "best of borrower's knowledge" standard.

To protect the value of the assignment, it is important for lender's counsel to impose restrictions that will prevent the borrower from undertaking any acts that might diminish the value of the leases (see §§5.8-5.9). Consequently, paragraph 2.9 prohibits the borrower from undertaking certain acts that may affect the value of the assignment without obtaining the lender's prior written consent. Of all the provisions in the assignment, 2.9 is probably the one for which the borrower most often requests revisions (see, *e.g.,* paragraph 2.10 in §5.14).

The borrower often suggests that, as the landlord, it is too tightly restricted by paragraphs 2.4 and 2.9, particularly as to its not being able to amend, modify, extend, or terminate a lease or commence an action for unlawful detainer. For example, when a tenant is in default, the landlord has the right to terminate the lease by serving a notice to pay rent

(or cure the default) or quit that includes an election to terminate the lease. The borrower will usually argue (often persuasively) that the clause restrictions may be valid as to major tenant leases but that, with respect to small office building or shopping center tenants, more flexibility should be given in order to allow the borrower to deal with tenants without involving the lender (who may be located out of state, and whose delay in reviewing the proposed action might unnecessarily inhibit the borrower's ability to respond quickly to the default).

Lenders often agree to a reasonable revision of the absolute restrictions in paragraph 2.9, and, at a minimum, may agree that, if written consent is requested by the borrower and the lender does not respond within a given period of time, consent shall be deemed to have been given. Large lenders frequently oppose any implied consent provision for fear that the notice will not get to the right person within the time limit allowed. In this situation, paragraph 9 may be revised to require a second notice before implied consent is triggered; similar compromises may also be acceptable.

As a practical matter, particularly with major tenants, the borrower will want to negotiate some type of nondisturbance and recognition protections as a condition to subordinating a lease. For further discussion of lease subordination, see Retail Leasing: Drafting and Negotiating the Lease, chap 44 (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease, chap 28 (Cal CEB 1996); California Mortgages, Deeds of Trust, and Foreclosure Litigation §§6.90-6.96, 9.74-9.87 (4th ed Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.14 E. Form: Permitted Leases

§5.14 E. Form: Permitted Leases

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5.14-1 Permitted leases

2.10. Permitted Leases. Despite _ _[*e.g., paragraph 2.9*]_ _ of this Assignment, Borrower need NOT obtain Lender's prior written consent when dealing with Leases (or renewals or extensions of leases) that are substantially in accordance with a form lease preapproved by Lender and that DO NOT have ANY of the following characteristics: (a) premises of more than _ _[*e.g., 20 percent*]_ _ of the net rentable area of the Mortgaged Property (*i.e.*, approximately _ _[*number of square feet*]_ _); (b) initial lease term of more than _ _[*e.g., 10 years*]_ _; or (c) base income of less than _ _[*dollar amount*]_ _ per rentable square foot per month full service net (triple net) of concessions. Borrower, however, shall provide Lender with true and complete copies of all fully executed lease documents, including those specifically permitted above.

Comment: Borrowers usually need and request some flexibility to enter into new leases without consulting the lender as mentioned above. Lenders often find it necessary or prudent to provide such flexibility. This provision attempts to grant limited rights while preserving lender protections. See §5.8 and Comment in §5.13.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.15 F. Form: Term

§5.15 F. Form: Term

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5.15-1 Term

3. Term. This Assignment shall continue in full force and effect until (a) the Indebtedness is paid in full and (b) the Obligations are fully satisfied. A full and complete release and reconveyance of the Deed of Trust shall operate as a full and complete release of all of Lender's rights and interest under this Assignment. On the recordation of a full and complete release and reconveyance, this Assignment shall thereafter be void and of no further effect.

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§5.16 G. Form: Borrower's Right to Collect Rents

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5.16-1 Borrower's right to collect rents

4. Borrower's Rights.

4.1. Borrower's Right to Collect Rents. As long as an Event of Default does not occur under any of the Loan Documents, Borrower is entitled to enforce the Leases, to operate, maintain, repair, and restore the Mortgaged Property, and to collect, retain, use, and hold the Rents, all subject to and in accordance with the Loan Documents. Except as provided in _ _[*e.g., paragraph 2.9*]_ _, Borrower shall apply any Rents it receives to the payments as they become due on the Indebtedness, taxes, assessments, water charges, sewer expenses, and other governmental charges levied, assessed, or imposed on the Mortgaged Property, insurance premiums, operation and maintenance charges relating to the Mortgaged Property, and other obligations of Borrower under the Leases before using such proceeds for any other purpose.

Comment: This paragraph follows the dictate of CC §2938 that all assignments of rents and leases are for security and that, unless proper enforcement is undertaken after an event of default, the borrower is entitled to the rents. On enforcement, see §5.5.

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§5.17 H. Form: Termination of Borrower's Rights

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.10-5.34.

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5.17-1 Termination of borrower's rights

4.2. Termination of Borrower's Rights. From and after the occurrence of an Event of Default under any of the Loan Documents, Lender shall have the right to enforce its rights to receive Rents under this Assignment and to terminate the rights granted to Borrower in _ _[*e.g., paragraph 4.1*]_ _. On such enforcement, as provided in _ _[*e.g., paragraph 5.1*]_ _, Borrower shall promptly deliver to Lender all Rents then held by Borrower, and Lender shall immediately be entitled to receive and apply all Rents. Borrower grants and assigns to Lender the right, at its option, to enter the Mortgaged Property in person, by agent, or by court-appointed receiver to collect the Rents. After such enforcement, Lender in its sole discretion may apply any Rents collected as provided in _ _[*e.g., paragraph 6*]_ _. Failure of or discontinuance by Lender at any time, or from time to time, to collect any Rents shall not in any manner affect the subsequent enforcement by Lender at any time, or from time to time, of the right, power, and authority to collect the Rents. The receipt and application by Lender of all such Rents, after execution and delivery of declaration of default and demand for sale or during the pendency of trustee sale proceedings under the Deed of Trust, shall not cure such breach or default nor affect such sale proceedings, or any sale made under the Deed of Trust. Neither anything in this Assignment nor the exercise of the right by Lender to collect the Rents shall be, or shall be construed to be, an affirmation by Lender of any Lease or option.

If the Rents are insufficient to meet the costs, if any, of taking control of the operation and management of the Mortgaged Property and collecting the Rents, any funds expended by Lender for such purposes shall become Indebtedness of Borrower to Lender secured by this Assignment and the Deed of Trust. Unless Lender and Borrower agree in writing to other payment terms, such amounts shall be payable on notice from Lender to Borrower requesting payment, and shall bear interest from the date of disbursement at the rate stated in the Note, unless payment of interest at such rate would be contrary to Governmental Requirements, in which event such amounts shall bear interest at the highest rate that may be collected from Borrower under Governmental Requirements.

Borrower expressly understands and agrees that Lender shall have no liability to Borrower or any other person for Lender's failure or inability to collect Rents or for failing to collect such Rents in an amount that is equal to the fair market rental value of the Mortgaged Property. Borrower understands and agrees that neither the transfer of Rents to Lender, nor Lender's exercise of any of its rights or remedies, under this Assignment or the Deed of Trust shall be deemed to make Lender a "mortgagee in possession" or otherwise responsible or liable in any manner with respect to the Mortgaged Property or the use, occupancy, enjoyment, or operation of all or any portion of it, unless Lender, in person or by agent, assumes actual possession of the Mortgaged Property.

Neither the appointment of a receiver for the Mortgaged Property by any court at the request of Lender or by agreement with Borrower nor the entering into possession of the Mortgaged Property or any part of it by such receiver shall be deemed to make Lender a "mortgagee in possession" or otherwise responsible or liable in any manner for the Mortgaged Property or the use, occupancy, enjoyment, or operation of all or any portion of it.

From and after the occurrence of an Event of Default, any and all Rents collected or received by Borrower shall be accepted and held for Lender in trust and shall not be commingled with Borrower's funds and property, but shall be promptly paid over to Lender.

Comment: Because of an apparent clerical error in CC §2938(c), if not for other reasons, lender's counsel should include a cross-default provision, or a definition of default, which provides that a default under the loan constitutes a

default under the assignment or deed of trust. Section 2938(c) provides that the creditor may enforce its rights after a default by the "assignor." Read literally, this section prevents enforcement if the assignor is not the borrower and the borrower is in default, absent such a cross-default provision or definition. On the use of rents, see §5.7. For general discussion of §2938(c) and the duties and liabilities of a mortgagee in possession, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 6 (4th ed Cal CEB 2009).

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§5.18 I. Form: Enforcement Actions

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5.18-1 Enforcement actions

5. Lender's Rights.

5.1. Enforcement Actions. After an Event of Default under any of the Loan Documents, Lender may exercise its rights to collect Rents and its other rights under this Assignment by one or more of the following methods (collectively, the Enforcement Actions, and individually, an Enforcement Action) according to Civil Code §2938(c) or any successor statute:

5.1.1. Petitioning a court of competent jurisdiction to appoint a receiver to collect Rents;

5.1.2. Obtaining possession of Rents;

5.1.3. Giving written notice to one or more Tenants, demanding a turnover of Rents according to Civil Code §2938(c) and (k);

5.1.4. Giving written notice to Borrower demanding a turnover of Rents; or

5.1.5. Taking any other action recognized under law to enforce this Assignment and the right to collect Rents.

Comment: Enforcement actions 5.1.1.-5.1.4. in this paragraph track the authorized enforcement actions set forth in CC §2938(c) (see §5.5). For comprehensive discussion of enforcement of rent assignments, including strategies, Practice Tips, litigation forms, and notices, as well as procedures and practical considerations regarding a court-appointed receiver, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 6 (4th ed Cal CEB 2009).

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§5.19 J. Form: Collection by Lender

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5.19-1 Collection by lender

5.2. Collection by Lender. Following an Enforcement Action after the occurrence of an Event of Default under any of the Loan Documents (whether or not Lender has commenced foreclosure), Lender may collect all or any portion of the Rents, including, without limitation, all Rents accrued and unpaid as of such date, directly or through a court-appointed receiver, together with, without limitation, the right to:

5.2.1. Give notice to the Tenants in accordance with _ _[*e.g., paragraph 7*]_ _ and, with or without taking possession of the Mortgaged Property, demand that all Rents, including, without limitation, all Rents accrued and unpaid as of such date, under the Leases be paid to Lender;

5.2.2. Settle, compromise, release, extend the time to pay, and make allowances, adjustments, and discounts of any Rents or other obligations under the Leases; enforce payment of Rents and other rights under the Leases; prosecute any action or proceeding; and defend against any claim with respect to Rents and Leases;

5.2.3. Enter into possession of the Mortgaged Property; assume control with respect to, and pay all expenses incurred in connection with, the development, operation, maintenance, repair, or restoration of the Mortgaged Property; enforce any or all provisions in the Leases and collect all Rents due; apply all Rents received by Lender as provided (_ _[*e.g., in paragraph 6*]_ _); amend, modify, extend, renew, and terminate any or all Leases; execute new Leases and do all other acts that Lender shall determine, in its sole discretion, to be necessary or desirable to carry out the purposes of this Assignment; and

5.2.4. Specifically enforce this Assignment and use all other legal and equitable measures that Lender deems necessary or proper in order to enforce this Assignment and collect the Rents.

At Lender's request, Borrower shall deliver a copy of this Assignment to all Tenants under a Lease and to each manager and managing agent or operator of the Mortgaged Property. Borrower irrevocably directs all Tenants, managers, managing agents, or operators of the Mortgaged Property, without any requirement for notice to or consent by Borrower, to comply with any demands of Lender under this Assignment and to turn over to Lender on demand all Rents that Borrower receives.

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§5.20 K. Form: Application of Rents; Security Deposits

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5.20-1 Application of rents; security deposits

6. Application of Rents; Security Deposits. All Rents received by Lender under this Assignment shall be applied by Lender, in its sole discretion and in the order it elects, to any of the following:

(a) The costs and expenses of collecting the Rents, or otherwise enforcing or defending the terms of, or Lender's rights under, this Assignment, including, without limitation, reasonable Attorney Fees and costs;

(b) The costs and expenses incurred in connection with the development, operation, ownership, maintenance, repair, or restoration of the Mortgaged Property, including (i) rentals and other charges payable by Borrower under any ground lease or other agreement affecting the Mortgaged Property; (ii) electricity, telephone, water, and other utility costs; taxes, assessments, water charges, sewer expenses, and other utility and governmental charges; (iii) insurance premiums; (iv) costs and expenses of any litigation affecting the Mortgaged Property, the Leases, or the Rents; and (v) employees' wages and salaries, agents' commissions, and Attorney Fees and expenses;

(c) The establishment of reasonable reserves for working capital and for anticipated costs and expenses relating to the Mortgaged Property, including, without limitation, capital improvements that may be reasonably necessary or desirable or that may be required by law; or

(d) The payment of the Indebtedness.

Borrower further agrees that all Rents received by Lender from Tenants may be allocated first, if Lender so elects, to the payment of all current obligations of such Tenants under their Leases and not to amounts that may be accrued and unpaid as of the date of Lender's taking an Enforcement Action after an Event of Default. Lender may, but has no obligation to, pursue Tenants for the payment of Rent that may be due under their Leases for any period before the exercise of Lender's rights by taking an Enforcement Action or that may become due after such exercise. Despite anything to the contrary in this Assignment, Lender shall not be liable to Tenants for the payment or return of security deposits under Leases unless such deposits were paid to and received by Lender. Borrower shall indemnify, protect, defend, and hold Lender harmless from and against any and all losses, claims, damages, liabilities, costs, and expenses of any nature (including reasonable Attorney Fees and costs) arising from all claims by Tenants with respect to such deposits. Borrower further agrees that the collection of Rents by Lender and the application of such Rents by Lender to the costs, expenses, and obligations referred to in this _ _[*e.g., paragraph 6*]_ _ shall not cure or waive any Event of Default or invalidate any act (including, but not limited to, any sale of all or any portion of the Mortgaged Property or any property now or later securing the Loan) done in response to or as a result of such Event of Default.

Comment: Despite these reserved rights, under CC §2938(g)(1) the assignor (borrower) and other assignees may require the lender collecting rents to apply them in certain ways, as discussed in §5.7. But, until so requested, this provision allows the lender to apply rents in its discretion to the items listed in the assignment because CC §2938(c) requires that lenders apply rents "to the debt or otherwise in accordance with the assignment or the… instrument evidencing the obligation." For further discussion of assignor rights from an enforcement perspective, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 6, 11 (4th ed Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.21 L. Form: Tenants' Obligations and Rights

§5.21 L. Form: Tenants' Obligations and Rights

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5.21-1 Tenant's obligations and rights

7. Tenants' Obligations and Rights. Borrower and Lender agree that all Tenants shall be bound by and required to comply with the provisions of this Assignment. To further the purpose and effectiveness of this Assignment, Borrower and Lender agree as follows:

7.1. Notice to Tenants. With respect to Leases entered into before this Assignment, if Lender so requests, Borrower shall (a) notify all Tenants of the existence of this Assignment and the rights and obligations of Borrower and Lender under it and (b) obtain each Tenant's agreement to be bound by and comply with this Assignment.

7.2. Reference in Leases. All Leases executed after this Assignment with respect to the Mortgaged Property or any portion of it shall contain a reference to this Assignment and shall state that all Tenants shall be bound by and shall comply with this Assignment.

7.3. Notice Following Event of Default. From and after the occurrence of an Event of Default under any of the Loan Documents, Lender may, at its option, send Tenants a notice that (a) an Event of Default has occurred and Lender has revoked Borrower's right to collect the Rents; (b) Lender has elected to exercise its rights under this Assignment; and (c) Tenants are directed to thereafter make all payments of Rents, including, without limitation, all Rents accrued and unpaid as of the date of the notice, and to perform all obligations under its Lease to or for the benefit of Lender or such party as Lender shall direct.

7.4. Payments by Tenants. On receipt of any such notice from Lender, all Tenants are hereby instructed by Borrower and Lender to comply with such notice, to make all payments of Rents, including, without limitation, all Rents accrued and unpaid as of the notice date, and to perform all obligations under its Lease to and for the benefit of Lender or such party as Lender shall direct. Such notice and direction shall remain effective until the first to occur of (a) the receipt by Tenants of a subsequent notice from Lender directing another method of payment of Rents; (b) the appointment of a receiver, in which event Tenants shall then pay Rents and perform all obligations under the Leases as such receiver may direct; or (c) the issuance of an order by a court of competent jurisdiction terminating this Assignment or otherwise directing another method of payment of Rents.

7.5. Reliance by Tenants. Tenants who receive a notice from Lender under this Assignment shall be entitled to rely on such notice and shall not be required to investigate or ascertain the validity or accuracy of such notice or the validity or enforceability of this Assignment. Borrower shall indemnify, protect, defend, and hold Tenants harmless from and against any and all expense, loss, claims, damage, or liability arising from the Tenants' compliance with such notice or performance of the obligations under their Leases by the Tenants made in good faith in reliance on such notice.

7.6. No Liability by Lender. None of the following acts shall cause Lender to assume or be bound by the provisions of any Lease: (a) payment of Rents to Lender under any such notice; (b) performance of the obligations under any Lease to or for the benefit of Lender or such party as Lender directs; (c) enforcement by Lender of any provision in any Lease.

7.7. Benefit of Tenants. The provisions of this _ _[*paragraph 7*]_ _ are expressly made for the benefit of, and shall be binding on and enforceable by, all Tenants under their Leases.

Comment: Civil Code §2938(d) establishes the circumstances in which a tenant is entitled, and in fact is required, to make rent payments to the lender under an assignment of rents. For further discussion of tenant rights and obligations

under rents assignments, see California Mortgages, Deeds of Trust, and Foreclosure Litigation §§6.50-6.56 (4th ed Cal CEB 2009).

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§5.22 M. Form: Further Assurances

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5.22-1 Further assurances

8. Further Assurances. Borrower agrees to take such actions and execute such other documents as may be reasonably necessary to evidence this Assignment and to establish the priority and carry out the intent and purpose of this Assignment. Within _ _[*e.g., 20 days*]_ _ after Lender's request, Borrower shall (a) execute, deliver, and record any such documents, including, without limitation, a specific assignment of any existing or future Lease, in form and substance reasonably satisfactory to Lender; and (b) execute and deliver to Lender, and cause the Tenants under the Leases, and any other party to, or guarantor of, the Leases, to execute and deliver to Lender, subordination and attornment agreements and estoppel certificates, in form and substance reasonably satisfactory to Lender.

Comment: Existing leases often require the addition of nondisturbance and recognition protections for the tenant if the landlord enters into a secured loan transaction by giving a deed of trust on the property. For further discussion, see Retail Leasing: Drafting and Negotiating the Lease, chap 44 (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease, chap 28 (Cal CEB 1996); California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 6 (4th ed Cal CEB 2009).

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5.23-1 Indemnity

9. Indemnity. Borrower shall indemnify, protect, defend, and hold Lender harmless from all losses, claims, damages, liabilities, costs, or expenses of any nature (including reasonable Attorney Fees and costs) that Lender incurs, arising from or relating to any of the Leases or this Assignment or because of any alleged obligation, undertaking, or inaction on Lender's part to perform or discharge any covenants or agreements in any of the Leases, except to the extent arising from Lender's gross negligence or willful misconduct or arising after the date, if ever, that Lender takes title to the Mortgaged Property through foreclosure of the Deed of Trust or a deed in lieu of foreclosure. Any amount incurred by Lender and covered by this indemnity clause shall be payable by Borrower on demand and shall bear interest at the Default Rate from the date of demand until it is fully paid.

Comment: On negotiating these types of clauses, see Akawie, *Down to Earth: Tips on Negotiating Indemnity Provisions*, 21 CEB Real Prop L Rep 101 (May 1998).

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5.24-1 Scope of lender responsibility

10. Lender Not Responsible for Borrower's Obligations. Nothing in this Assignment shall operate or be construed to obligate Lender to perform any of the terms, covenants, and conditions in any Lease or otherwise to impose any obligation on Lender with respect to any Lease, including, without limitation, any obligation arising from any covenant of quiet enjoyment in any Lease in the event the Tenants under such Lease are joined as parties in any foreclosure action that terminates the estate of such Tenants. Before Lender's actual entry into and taking possession of the Mortgaged Property, this Assignment shall not operate to place on Lender any responsibility for the development, operation, control, maintenance, repair, or restoration of the Mortgaged Property or any portion of it, and the execution of this Assignment by Borrower shall constitute conclusive evidence that all such responsibility is and shall be that of Borrower.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.25 P. Form: Covenants Running With Land

§5.25 P. Form: Covenants Running With Land

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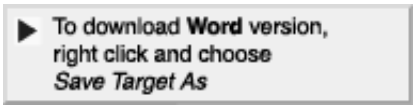

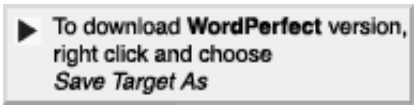

5.25-1 Covenants running with land

11. <u>Covenants Running With Land</u>. Borrower's covenants under this Assignment and its provisions shall be deemed covenants running with the land and shall be binding on all grantees, successors, and assigns of Borrower, and its Tenants, subtenants, licensees, other occupants of the Mortgaged Property, and their successors and assigns. Nothing in this paragraph shall be construed to waive any restrictions on leases and transfers of the Mortgaged Property in this Assignment or in _ _[*e.g., paragraphs 19 and 20*]**_ _ of the Deed of Trust.**

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§5.26 Q. Form: Bankruptcy

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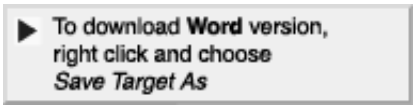

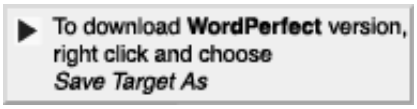

5.26-1 Bankruptcy

12. Bankruptcy.

12.1. Tenants' Bankruptcy. On or at any time after the occurrence of an Event of Default, Lender shall have the right to proceed in its own name or in Borrower's name in any claim, suit, action, or proceeding relating to the rejection of any Leases, including, without limitation, the right to file and prosecute, to the exclusion of Borrower, any proofs of claim, complaints, motions, applications, notices, and other documents, in any case involving Tenants under such Leases under the Bankruptcy Code.

12.2. Borrower's Bankruptcy. If a petition under the Bankruptcy Code is filed by or against Borrower, and Borrower, as lessor under any Lease, decides to reject such Lease under Title 11 United States Code §365(a), then Borrower shall give Lender at least _ _[*e.g., 10 days*]_ _ notice of the date on which Borrower shall file its application in the bankruptcy court for permission to reject the Lease. Lender shall have the right, but not the obligation, to serve on Borrower within such _ _[*e.g., 10-day*]_ _ period a notice stating that (a) Lender demands that Borrower assume and assign the Lease to Lender under Title 11 United States Code §365 and (b) Lender covenants to cure or provide adequate assurance of future performance under the Lease. If Lender serves on Borrower the notice described in the preceding sentence, Borrower shall not seek to reject the Lease and shall comply with the demand provided for in clause (a) of the preceding sentence within _ _[*e.g., 30 days*]_ _ after the notice has been given, subject to the performance by Lender of the covenant described in clause (b) of the preceding sentence.

Comment: For discussion of bankruptcy considerations in real estate secured transactions, including the effect of the 2005 amendments to federal bankruptcy law, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 7, 11 (4th ed Cal CEB 2009). The borrower may argue that this paragraph interferes with its federal rights conferred by the Bankruptcy Code and may seek to negotiate this paragraph or have it invalidated during a bankruptcy.

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§5.27 R. Form: Governing Law

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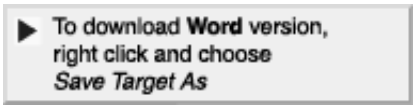

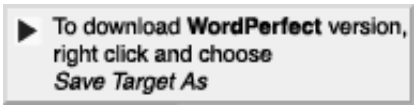

5.27-1 Governing law

13. Governing Law. This instrument shall be deemed to have been made in the State of California, and the validity of this Assignment and the other Loan Documents, their construction, interpretation, and enforcement, and the parties' rights under such documents and concerning the Mortgaged Property, shall be decided under, governed by, and construed in accordance with the laws of the State of California. The parties agree that all actions or proceedings arising in connection with this Assignment and the other Loan Documents shall be tried and litigated only in state courts located in the County of _ _[*name*]_ _, State of California, or the federal courts located in the _ _[*e.g., Southern*]_ _ District of California. Borrower waives any right Borrower may have to assert the doctrine of forum non conveniens or to object to such venue.

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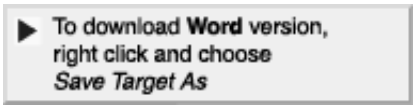

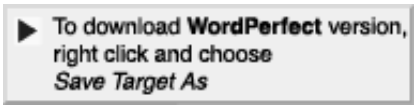

5.28-1 Liability for acts or omissions

14. Liability for Acts or Omissions. Lender shall not be liable or responsible for its acts or omissions under this Assignment, except for Lender's own gross negligence or willful misconduct, or be liable or responsible for any acts or omissions of any agent, attorney, or employee of Lender, if selected with reasonable care.

Comment: This provision may be unenforceable, and the borrower will likely object to it. See Comment in §4.106.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.29 T. Form: Remedies Are Cumulative

§5.29 T. Form: Remedies Are Cumulative

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5.29-1 Remedies are cumulative

15. Remedies Are Cumulative. Each remedy in this Assignment is separate and distinct and is cumulative to all other rights and remedies provided by this Assignment or by Governmental Requirements, and each may be exercised concurrently, independently, or successively, in any order whatsoever.

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§5.30 U. Form: Severability

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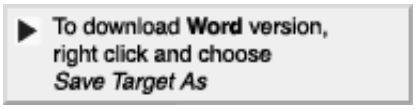

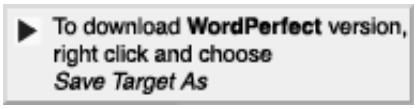

5.30-1 Severability

16. Severability. If any provision of the Loan Documents, or the application of them to the circumstances, is held void, invalid, or unenforceable by a court of competent jurisdiction, the Loan Documents, and the applications of such provision to other parties or circumstances, shall not be affected thereby, the provisions of the Loan Documents being severable in any such instance.

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§5.31 V. Form: General Provisions

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5.31-1 General provisions

17. General Provisions.

17.1. Successors and Assigns. Subject to _ _[*e.g., paragraphs 19 and 20*]_ _ of the Deed of Trust, this Assignment applies to, inures to the benefit of, and binds the respective heirs, legatees, devisees, administrators, executors, successors, and assigns of each party to this Assignment.

17.2. Authorized Agents. In exercising any right or remedy, or taking any action provided in this Assignment, Lender may act through its employees, agents, or independent contractors as Lender expressly authorizes.

17.3. Gender and Number. Whenever the context so requires in this Assignment, the masculine gender includes the feminine and neuter, the singular number includes the plural, and vice versa.

17.4. Captions. Captions and paragraph headings used in this Assignment are for convenience of reference only, are not a part of this Assignment, and shall not be used in construing it.

17.5. No Waiver. The exercise or nonexercise by Lender of the rights granted in this Assignment, or the collection and application of Rents by Lender or its agent, shall not constitute a waiver of any default by Borrower under this Assignment or any other Loan Document. No action or failure to act by Lender with respect to any obligations of Borrower under the Loan Documents, or any security or guaranty given for the payment or performance of Borrower's obligations, shall in any manner affect, impair, or prejudice any of Lender's rights and privileges under this Assignment, or discharge, release, or modify any of Borrower's duties or obligations under this Assignment.

17.6. Notices. All notices required to be given under this Assignment shall be in writing and shall be given in the manner directed in the Deed of Trust.

17.7. Joint and Several. If more than one Person is named as Borrower each obligation of Borrower under this Assignment shall be the joint and several obligation of each such Person.

17.8. Counterparts. This Assignment may be executed in any number of counterparts, each of which when so executed and delivered shall be deemed to be an original and all of which taken together shall constitute one and the same instrument. Signature and acknowledgment pages may be detached from their counterparts and attached to a single copy of this Assignment to physically form one document, which may be recorded.

17.9. Validity. Any Lease, or any amendment or modification to any Lease, that is entered into after the date of this Assignment and not in accordance with the terms and conditions of this Assignment and the Loan Documents shall be invalid at Lender's option.

17.10. Time Is of the Essence. As a material inducement and consideration to the parties entering into this Assignment, and but for this provision the parties would not enter into this Assignment, the parties agree that the performance in a timely manner of each deadline set forth in this Assignment before its expiration is of crucial importance to the parties. Failure by a party to timely perform an obligation before the deadline set forth in this Assignment (no matter for what reason, nor how soon thereafter it may have been performed, nor the lack of prejudice to the other party as the result of such nonperformance) shall result in a default by the nonperforming party or the failure of a condition, as appropriate. The parties expressly waive any equitable relief with respect to a missed deadline.

17.11. WAIVER OF JURY TRIAL. TO THE EXTENT NOW OR HEREAFTER PERMITTED BY LAW, BORROWER AND LENDER AGREE TO WAIVE THEIR RESPECTIVE RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED ON OR ARISING FROM THIS ASSIGNMENT. THE SCOPE OF THIS WAIVER IS INTENDED TO BE ALL-ENCOMPASSING OF ANY AND ALL DISPUTES THAT MAY BE FILED IN ANY COURT AND THAT RELATE TO THE SUBJECT MATTER OF THIS TRANSACTION, INCLUDING, WITHOUT LIMITATION, CONTRACT CLAIMS, TORT CLAIMS, BREACH OF DUTY CLAIMS, AND ALL OTHER COMMON LAW AND STATUTORY CLAIMS. BORROWER, AND, BY ITS ACCEPTANCE OF THE BENEFITS OF THIS ASSIGNMENT, LENDER EACH (A) ACKNOWLEDGES THAT THIS WAIVER IS A MATERIAL INDUCEMENT FOR BORROWER AND LENDER TO ENTER INTO A BUSINESS RELATIONSHIP, THAT BORROWER AND LENDER HAVE ALREADY RELIED ON THIS WAIVER BY ENTERING INTO THIS ASSIGNMENT OR ACCEPTING ITS BENEFITS, AS THE CASE MAY BE, AND THAT EACH SHALL CONTINUE TO RELY ON THIS WAIVER IN THEIR RELATED FUTURE DEALINGS, AND (B) FURTHER WARRANTS AND REPRESENTS THAT EACH HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL, AND THAT EACH KNOWINGLY AND VOLUNTARILY WAIVES ITS JURY TRIAL RIGHTS FOLLOWING CONSULTATION WITH LEGAL COUNSEL. THIS WAIVER IS IRREVOCABLE, MEANING THAT IT MAY NOT BE MODIFIED EITHER ORALLY OR IN WRITING, AND THIS WAIVER SHALL APPLY TO ANY SUBSEQUENT AMENDMENTS, RENEWALS, SUPPLEMENTS, OR MODIFICATIONS TO THIS ASSIGNMENT. IN THE EVENT OF LITIGATION, THIS ASSIGNMENT MAY BE FILED AS A WRITTEN CONSENT TO A TRIAL BY THE COURT.

Comment: The jury trial waiver is intentionally in boldface type and placed just before the borrower's signature to increase the likelihood that it will be enforced, to the extent that it is enforceable. Predispute waivers of jury trial are not currently enforceable under California law (see *Grafton Partners LP v Superior Court* (2005) 36 C4th 944, 32 CR3d 5), unless coupled with an agreement to arbitrate disputes or for judicial reference of disputes. See §§3.103, 4.58, and 4.115.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.32 W. Form: Signature

§5.32 W. Form: Signature

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.10-5.34.

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5.32-1 Signature

IN WITNESS WHEREOF, Borrower has executed and delivered this Assignment as of the date first written above.

Date: _ _ _ _ _ _

Borrower:

_ _[*Name of limited liability company*]_ _**, a California limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.33 X. Form: Acknowledgment

§5.33 X. Form: Acknowledgment

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.10-5.34.

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5.33-1 Acknowledgment

STATE OF CALIFORNIA)
COUNTY OF _ _[*name*]_ _)
)
_____)

On _ _[*date*]_ _, before me, _ _[*name and title of notary or witnessing officer*]_ __ who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signatures(s) on the instrument the persons(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of notary*]__ [*Notary's seal*]

Comment: The contents of the acknowledgment are exactly prescribed by CC §1189. See Comment in §4.117.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/5 The Assignment of Rents/§5.34 Y. Form: Legal Description of Property (Exhibit A)

§5.34 Y. Form: Legal Description of Property (Exhibit A)

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§5.10-5.34.

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5.34-1 Legal description of property (Exhibit A)

EXHIBIT A
Legal Description of Property

That certain real property located in the City of _ _[*name*]_ _, County of _ _[*name*]_ _, California, having a street address of _ _[*address*]_ _, more particularly described as:

[*Insert property description of record*]

Comment: The best source of the most accurate legal description of the property is the title company's preliminary report. Property descriptions, particularly if based on a metes and bounds method, are susceptible to typographical errors. If possible, the description should be reproduced reprographically. Errors can still occur, however, and close proofreading is essential when optical scanning is used to reproduce a property description. On property descriptions for deeds of trust, see §4.17.

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5A

The Environmental Indemnity

Thomas G. Roberts
Gary York

I. INTRODUCTION
- A. Scope and Limit of Chapter §5A.1
- B. Lender's Concerns §5A.2

II. LEGAL AND PRACTICAL CONSIDERATIONS
- A. Impact of California Antideficiency Laws and One-Action Rule
  - 1. Limits Imposed §5A.3
  - 2. Legislative Response §5A.4
    - a. Contract Action (CCP §736) §5A.5
    - b. Waiver of Security Interest (CCP §726.5) §5A.6
- B. Types of Environmental Indemnity §5A.7
  - 1. Secured Indemnities §5A.8
  - 2. Unsecured Indemnities §5A.9
  - 3. Third Party Indemnities §5A.10
- C. Borrower's Drafting Strategy §5A.11

III. FORM: ENVIRONMENTAL INDEMNITY AGREEMENT §5A.12

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I. INTRODUCTION

§5A.1 A. Scope and Limit of Chapter

Environmental indemnities are customarily required by lenders in commercial real estate transactions. They may be secured or unsecured and may be part of the deed of trust or a separate document. This chapter discusses the form of separate environmental indemnity agreement that lenders commonly include as part of their standard loan documentation in real estate secured transactions. The chapter also includes a brief discussion of the possible impact of California's antideficiency laws and one-action rule on environmental indemnities and the legislation that was passed to address those issues (§§5A.3-5A.6).

PRACTICE TIP: Although the form environmental indemnity agreement contains broad representations and warranties, the lender should not rely only on an indemnity. A site assessment should be undertaken during the due diligence phase of the transaction. See §§1.65, 1.70.

For a discussion of environmental indemnities in the deed of trust, see §4.47. For a form of environmental representations and indemnities in the deed of trust, see paragraph 24 in §4.89.

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§5A.2 B. Lender's Concerns

Lenders are concerned about hazardous substances that may be located on or in the vicinity of the secured property. In addition to certain due diligence items (see §§1.70, 4.47), lenders will also want an indemnity from the borrower (and/or an independent guarantor or other third party) that survives foreclosure, because that is when the lender's exposure truly arises. Laws relating to hazardous substances often impose liability on owners, no matter who caused the contamination. See, *e.g.,* statutes cited in Paragraph 1 of the form in §5A.12. Lenders have some statutory protection from liability if they purchase at the foreclosure sale, but (a) they do not want to take even a small risk of liability, and (b) the property may have substantially declined in value (or even become worthless) if hazardous substances are found to exist.

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II. LEGAL AND PRACTICAL CONSIDERATIONS

A. Impact of California Antideficiency Laws and One-Action Rule

§5A.3 1. Limits Imposed

During the 1980s, lenders became increasingly concerned about the impact of environmental laws on the value of real estate collateral and began drafting into their loan documents extensive environmental indemnities. In California, such environmental indemnities raised issues under California's antideficiency laws (CCP §§580a, 580b, 580d) and one-action rule (CCP §726). See Roberts, *California Antideficiency Laws and Environmental Indemnities*, 7 Cal Real Prop J 1 (Summer 1989). Lenders were concerned that if an environmental problem were discovered following a nonjudicial foreclosure sale, CCP §580d would prevent them from suing under the environmental indemnities contained in the loan documents. For discussion of §580d, see §3.49. Further, an action during the term of the loan on an environmental indemnity could be viewed as a violation of the one-action rule, and the one-action rule could be viewed as a bar to recovery on an environmental indemnity provision after the lender obtained a judgment in a judicial foreclosure action. On the one-action rule, see §3.49; for further discussion of environmental indemnities and antideficiency statutes, see California Mortgages, Deeds of Trust, and Foreclosure Litigation §4.56 (4th ed Cal CEB 2009).

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§5A.4 2. Legislative Response

In 1991, the California Legislature enacted the following statutes to address issues related to the enforceability of environmental indemnities in secured real estate loans:

- CCP §736, which under certain circumstances permits the lender to sue the borrower for breach of a contract relating to certain environmental provisions without first foreclosing on the security (see §5A.5); and
- CCP §726.5, which permits lenders who have environmentally impaired property to waive the security and sue the borrower on the note (see §5A.6).

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§5A.5 a. Contract Action (CCP §736)

Under CCP §736 a real estate secured lender may, under certain circumstances, commence litigation to enforce any "environmental provision" made by the borrower, and this action "shall not constitute an action within the meaning of [CCP §726(a)], or constitute a money judgment for a deficiency" in violation of CCP §580a, §580b, or §580d.

"Environmental provision" is defined as the borrower's written representation or covenant that relates to hazardous substances and that is made in connection with the origination, renewal, or modification of a real estate secured loan. CCP §736(f)(2). An environmental provision may be either secured or unsecured. It may be set forth in the deed of trust or in some other document. See California Mortgages, Deeds of Trust, and Foreclosure Litigation §4.56 (4th ed Cal CEB 2009).

Code of Civil Procedure §736 is not applicable to all real estate secured loans, however. The following are the preconditions to its application:

- The real property security must be commercial or contain in excess of 15 residential units;
- The secured obligation must exceed $200,000;
- The borrower must have caused the environmental impairment; and
- The loan must have been made, renewed, or modified on or after January 1, 1992.

NOTE: Not all cleanup costs normally covered by a lender's form of environmental indemnity are recoverable under CCP §736. Although §736(b)(1)-(2) permits a lender to recover response costs that are ordered by the government or those that are "reasonable and [in] good faith," no part of the secured debt is recoverable. See Mortgage Deed of Trust Foreclosure §4.56.

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§5A.6 b. Waiver of Security Interest (CCP §726.5)

Code of Civil Procedure §726.5(a) permits a lender whose loan is secured by real property to waive its security interest in the real property and to sue directly on the debt if the property is "environmentally impaired." Property is environmentally impaired if the remediation costs exceed 25 percent of the fair market value of all of the security for the loan or if it is on certain federal or state official lists of impaired property. CCP §726.5(e)(3). For the lender to have this right, the property must be either commercial property or in excess of 15 residential units. CCP §726.5(e)(5). Generally, the borrower or a related party must know of, or have caused, the contamination. CCP §726.5(d). The lender must foreclose on any other collateral for the debt, and the secured debt must have been made, renewed, or modified on or after January 1, 1992. See California Mortgages, Deeds of Trust, and Foreclosure Litigation §4.55 (4th ed Cal CEB 2009).

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§5A.7 B. Types of Environmental Indemnity

There are a wide variety of approaches in California to documenting environmental provisions in real estate secured loans. To some extent the variety of approaches reflects lawyers' preferences, but the variations also reflect the fundamental economic differences between transactions. Three common types of indemnities—secured, unsecured, and third-party indemnities—are discussed in §§5A.8-5A.10.

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§5A.8 1. Secured Indemnities

Usually lender's counsel will prepare loan documents that include environmental provisions in the deed of trust. Then through the securing clause of the deed of trust, which always provides that the obligations under the deed of trust are secured by the deed of trust, those environmental provisions are automatically secured obligations. See §4.47 for discussion of environmental indemnity as part of the deed of trust. For form securing clause, see §4.64. Pursuant to CCP §736, however, a lender may sue the borrower directly on those obligations even though the obligations are secured by real estate, despite the one-action rule.

Frequently lenders will also prepare a separate environmental indemnity agreement that recites that it is secured by the deed of trust. It also provides that it survives foreclosure, any deed given in lieu of foreclosure, or repayment of the loan. A separate environmental indemnity agreement provides the lender with a separate document to sue on, particularly in a situation in which the debt has been repaid or foreclosure has occurred.

Such secured environmental indemnities make particular sense in transactions with single-purpose borrowers. In such situations, the borrower has no other asset than the real estate.

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§5A.9 2. Unsecured Indemnities

If the borrower has substantial assets other than the real property secured by the deed of trust, the lender may elect to use an unsecured environmental indemnity agreement. This provides the lender with the protections of CCP §736 and the argument that, to the extent losses are not recoverable under §736, the antideficiency laws and one-action rule do not apply and the lender may sue on the environmental indemnity agreement without regard to CCP §§580b, 580d, and 726. Another approach would be to create two environmental indemnity agreements to be executed by the borrower, one secured and limited to those costs covered by CCP §736 and the other unsecured and expressly limited to costs not covered by §736; this is infrequently done.

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§5A.10 3. Third Party Indemnities

Often lenders will include an additional third party indemnitor who is usually a guarantor of the loan. In such instances, lenders will probably include in the environmental indemnity agreement all of the necessary suretyship waivers for fear that the environmental indemnity agreement might be viewed as a guaranty regarding the third party indemnitor. Consequently, some lenders simply add the obligations under the environmental indemnity agreement to a guaranty or similar document being signed by the guarantor and do not include the guarantor as a party to the environmental indemnity agreement.

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§5A.11 C. Borrower's Drafting Strategy

Lenders typically draft environmental indemnities extremely broadly. The borrower's counsel will want to attempt to add some limitations, especially if the Phase I report (see §1.65) shows no major environmental problems. These limitations may include the following:

- Making borrower's representations and warranties subject to those matters disclosed in any environmental report;
- Limiting borrower's representations to the "best knowledge and belief" of borrower or defined employees or officers of borrower (but the lender will resist this on the ground that if there is any risk about unknown matters, the risk should fall on the borrower);
- Permitting the borrower to use any hazardous substances normally used in the borrower's business, provided they are used in compliance with environmental laws;
- Permitting the borrower (and tenants and other occupants of the property) to contest demands for compliance or remediation or claims against the property under environmental laws, if the lender's interests are reasonably protected; and
- Excluding from the indemnity any losses caused by the lender or any successor in interest to the lender, such as following a foreclosure.

For more on Phase I reports and the California Environmental Quality Act (CEQA) (Pub Res C §§21000-21177), see Practice Under the California Environmental Quality Act (2d ed Cal CEB 2008).

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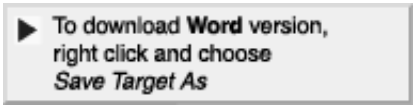
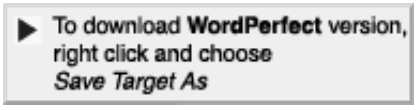
§5A.12 III. FORM: ENVIRONMENTAL INDEMNITY AGREEMENT





THIS ENVIRONMENTAL INDEMNITY AGREEMENT (Indemnity) is entered into as of _ _[*date*]_ _, by _ _[*name*]_ _, a _ _[*e.g., limited liability company*]_ _ (Indemnitor), to and for the benefit of _ _[*name*]_ _, a _ _[*e.g., corporation*]_ _ (Lender), and its successors, assigns, servicers, and participants, any party who now or hereafter holds an interest in the Loan described below, and the respective parent, subsidiary, and affiliated corporations of each of the foregoing, and the respective directors, officers, agents, attorneys, and employees of each of the foregoing (each of which shall be referred to in this Indemnity individually as an Indemnitee and collectively as the Indemnitees).

RECITALS

A. The Lender has agreed to make a loan in the maximum principal amount of _ _[*dollar amount*]_ _ (Loan) to Indemnitor, pursuant to that certain Loan Agreement of even date with this Indemnity executed by Indemnitor and the Lender (Loan Agreement).

B. The Indemnitor has concurrently with this Indemnity executed that certain Deed of Trust, Security Agreement, Assignment of Rents, and Fixture Filing of even date executed by Indemnitor, as trustor, to _ _[*name of trustee*]_ _, as trustee, in favor of the Lender, as beneficiary (Deed of Trust), which Deed of Trust encumbers the real property described on the attached *Exhibit A* (Mortgaged Property). The Lender has therefore made it a condition of the Lender's making the Loan that this Indemnity be executed and delivered by the Indemnitor in order to protect the Indemnitees from such liabilities, costs, and expenses as set forth in this Indemnity.

NOW, THEREFORE, in consideration of these Recitals and of the Lender agreeing to make the Loan, and other valuable consideration, the receipt of which is acknowledged, the Indemnitor represents, warrants, and agrees as follows:

1. *Definitions*. The following terms as used in this Indemnity shall have the meaning set forth in this Section.

The term "Environmental Law(s)" means any and all present or future laws (whether common law, statute, rule, regulation, or otherwise), permits, and other requirements of any federal or California governmental unit, or of any regional or local governmental unit with jurisdiction over the Mortgaged Property, for the protection of human health, the environment, or natural resources, or relating to any Hazardous Material or Hazardous Material Activity (including Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601 et seq.); Resource Conservation and Recovery Act of 1976 (RCRA) (42 USC §§6901 et seq.); Carpenter-Presley-Tanner Hazardous Substance Account Act (Health & S C §§25300 et seq.); Hazardous Waste Control Law (Health & S C §§25100 et seq.); Safe Drinking Water and Toxic Enforcement Act of 1986 (Health & S C §§25249.5 et seq.); Underground Storage of Hazardous Substances Act (Health & S C §§25280 et seq.); and Porter-Cologne Water Quality Control Act (Wat C §§13000 et seq.), and any past or future amendments to these acts).

The term "Hazardous Material(s)" shall include gasoline, petroleum products, explosives, radioactive materials, polychlorinated biphenyls, lead and lead-based paint, mold, radon gas, urea formaldehyde foam insulation, or related or similar materials, or any other substance, material, or waste now or hereafter defined, listed, or regulated as a pollutant or a hazardous or toxic substance, material, or waste by or pursuant to any Environmental Law, including asbestos.

The term "Hazardous Material Activity" means any actual storage, holding, use, release (including a release as defined in California Civil Code §2929.5), emission, discharge, generation, processing, abatement, removal, repair, remediation, closure, site restoration, cleanup or detoxification, disposal, handling, or transportation of any Hazardous Material from, under, in, at, on, or about the Mortgaged Property or the surrounding property, or

any other remedial act, activity, or occurrence that causes or would cause such event to exist.

The term "Losses" means any and all losses, liabilities, damages, demands, claims, actions, judgments, causes of action, assessments, penalties, costs, and expenses (including the reasonable fees and disbursements of outside legal counsel, accountants, consultants, and experts and the reasonable charges of in-house legal counsel and accountants), and all foreseeable and unforeseeable consequential damages (including costs of any and all investigation, cleanup, removal, remediation, closure, site restoration of any Hazardous Material, or any other remedial acts that are required to be performed on the Mortgaged Property by any Environmental Laws and all legal fees therefor.)

2. *Representations and Warranties*. Indemnitor represents and warrants, except as disclosed in the _ _[*describe any environmental reports that have been obtained*]_ _, copies of which have been delivered to the Lender, the following:

(a) Indemnitor and the Mortgaged Property are in compliance with all applicable Environmental Laws relating to the Mortgaged Property and the use of the Mortgaged Property;

(b) There are no Hazardous Materials in, on, under, or affecting the Mortgaged Property, except those in compliance with all applicable Environmental Laws, and disclosed to Lender in writing, and there is no asbestos or asbestos-containing construction materials in, on, under, or affecting the Mortgaged Property;

(c) Indemnitor has not engaged in any Hazardous Material Activity at, in, on, under, about, or from the Mortgaged Property except in compliance with all applicable Environmental Laws and as disclosed in writing to Lender;

(d) Neither Indemnitor nor any agent, affiliate, tenant, or partner of Indemnitor has received any notice or advice from any governmental agency or any source (including third parties) whatsoever with respect to Hazardous Materials in, on, at, under, about, from, or affecting the Mortgaged Property; nor has any of them received a written notice from any other third party alleging the occurrence of any Hazardous Material Activity in violation of any applicable Environmental Laws or demanding payment or contribution for environmental damage or injury to the Mortgaged Property; and Indemnitor has no knowledge of any prior owner or occupant of the Mortgaged Property receiving any such notice or advice;

(e) No portion of the Mortgaged Property contains or is located within 2000 feet of a significant disposal of hazardous waste within the meaning of California Health and Safety Code §25221 (the Code) that could cause the Mortgaged Property to be classified as a hazardous waste property or a border zone property under the Code; and

(f) No underground storage tanks or underground Hazardous Materials deposits are located on the Mortgaged Property.

3. *Covenants of Indemnitor*. Indemnitor covenants as follows:

(a) The Mortgaged Property is and shall be kept free of asbestos and asbestos-containing construction materials.

(b) Neither Indemnitor nor any occupant of the Mortgaged Property shall use, transport, store, treat, generate, handle, dispose of, or in any manner deal with Hazardous Materials on, in, at, about, or from the Mortgaged Property, except in compliance with all applicable federal, state, and local laws, ordinances, rules and regulations, including Environmental Laws, and as disclosed in writing to Lender; nor shall Indemnitor or any occupant cause the Mortgaged Property to become subject to regulation as a hazardous waste treatment, storage, or disposal facility under any Environmental Law.

(c) Indemnitor shall comply with, and ensure compliance by all occupants of the Mortgaged Property with, all Environmental Laws, and shall keep the Mortgaged Property free and clear of any liens imposed pursuant to any Environmental Laws.

(d) In the event that Indemnitor receives any notice or advice from any governmental agency or any source whatsoever with respect to Hazardous Materials in, on, under, from, or affecting the Mortgaged Property, Indemnitor shall immediately notify Lender.

(e) Indemnitor shall not allow to exist on, under, or about the Mortgaged Property any underground storage tanks or underground Hazardous Materials deposits.

(f) If at any time Hazardous Materials are discovered in, on, under, or about the Mortgaged Property that do not comply with the foregoing provisions of this paragraph _ _[*e.g., 3*]_ _, Indemnitor shall inform Lender of such and Indemnitor's proposed remedial program, and Indemnitor shall remove such Hazardous Materials from the Mortgaged Property or the groundwater underlying the Mortgaged Property or remediate the same in accordance with all requirements of the appropriate governmental entities. All remedial work shall be conducted and completed promptly, at Indemnitor's sole cost and expense, by a contractor or contractors approved by Lender.

(g) Indemnitor, at its sole expense, shall (i) perform any environmental site assessment or other investigation of environmental conditions in connection with the Mortgaged Property (including sampling, testing, and analysis of soil, water, air, building materials and other materials and substances, whether solid, liquid, or gas), pursuant to Lender's written request upon Lender's reasonable belief that the Mortgaged Property is not in full compliance with Environmental Laws or Permits; and (ii) if requested by Lender, share all reports, results, and correspondence related to such assessments or investigations with Lender. Indemnitor agrees to have any written reports structured to allow Lender (and any other party designated by Lender) to rely on such reports.

(h) Indemnitee has the right, but not the obligation, after reasonable prior notice to Indemnitor to enter upon the Mortgaged Property at all reasonable times to assess the environmental condition of the Mortgaged Property, including to conduct any environmental assessment or audit (the scope of which shall be determined in Indemnitee's sole discretion) and to take samples of soil, groundwater or other water, air quality, and building materials, and to conduct other invasive testing. Such assessment or audit shall be conducted in such a manner to minimize interference with the conduct of business at the Mortgaged Property. Indemnitor agrees to reasonably cooperate in connection therewith. If any such undertaking discloses that a violation of, or a liability under, any Environmental Law exists, or if such undertaking was required or prescribed by any Environmental Law or governmental agency, or if the inspection is performed while an Event of Default exists under any of the Loan Documents, then Indemnitor shall pay all reasonable costs and expenses incurred in connection with such undertaking; otherwise, the costs and expenses of such undertaking shall be paid by Indemnitee.

4. *Indemnification From Indemnitor.*

(a) To the fullest extent permitted by law, Indemnitor agrees to indemnify, defend, protect, and hold harmless the Indemnitees from and against any and all Losses suffered, imposed on, or incurred by such Indemnitee or asserted against such Indemnitee arising out of or as a result of any of the following:

(i) Any breach of the representations, warranties, and covenants made by Indemnitor in Section _ _[*e.g., 2*]_ _ of this Indemnity;

(ii) Any investigation, inquiry, order, hearing, action, or other proceeding by or before any governmental agency in connection with any Hazardous Material Activity;

(iii) Any personal injury (including wrongful death) or property damage (real or personal) arising out of or related to any occurrence or violation described in subparagraph _ _[*e.g., 4(a)(i)*]_ _; or

(iv) Any claim, demand or cause of action, or any action or other proceeding, whether meritorious or not, brought or asserted against any Indemnitee that directly or indirectly relates to, arises from, or is based on any of the matters described in subparagraphs _ _[*e.g., 4(a)(i)-(iii)*]_ _, or any allegation of any such matters.

(b) The indemnification provided in this Indemnity shall apply to and include claims or actions brought by or on behalf of employees of Indemnitor. Indemnitor agrees that a separate action may be brought to enforce the provisions in this Indemnity, including an action in accordance with the provisions of California Code of Civil Procedure §736, which separate action shall in no way be deemed to be an action within the meaning of California Code of Civil Procedure §726(a), or constitute a money judgment for a deficiency or a deficiency judgment within the meaning of California Code of Civil Procedure §580a, §580b, §580d, or §726(b).

5. *Survival of Obligations*. The rights of each Indemnitee under this Indemnity shall be in addition to any other rights and remedies of such Indemnitee against any Indemnitor under any other document or instrument now or hereafter executed by such Indemnitor, or at law or in equity (including any right of reimbursement or contribution pursuant to CERCLA), and shall not in any way be deemed a waiver of any of such rights. Each Indemnitor agrees that it shall have no right of contribution (including any right of contribution under CERCLA) or subrogation against any other Indemnitor under this Indemnity unless and until all obligations of such Indemnitor to each Indemnitee have been satisfied. Each Indemnitor further agrees that, to the extent that the waiver of its rights of subrogation and contribution as set forth in this Indemnity is found by a court of competent jurisdiction to be void or voidable for any reason, any rights of subrogation or contribution such Indemnitor may have shall be junior and subordinate to the rights of each Indemnitee against each Indemnitor under this Indemnity.

6. *Interest*. All obligations of the Indemnitor under this Indemnity shall be payable on demand, and any amount due and payable under this Indemnity to any Indemnitee by any Indemnitor that is not paid within _ _[*e.g., thirty (30)*]_ _ days after written demand from an Indemnitee with an explanation of the amounts demanded shall bear interest from the date of such demand until paid at the rate of _ _[*e.g., ten percent (10%)*]_ _ per annum.

7. *Payment of Costs and Expenses*. The Indemnitor shall pay to each Indemnitee all costs and expenses (including the reasonable fees and disbursements of any Indemnitee's outside legal counsel and the reasonable charges of any Indemnitee's in-house legal counsel) incurred by such Indemnitee in connection with, or the enforcement of, this Indemnity.

8. *Binding on Successors, Interpretation, Joint and Several Liability*. This Indemnity shall be binding upon each Indemnitor, its heirs, representatives, administrators, executors, successors, and assigns and shall inure to the benefit of and shall be enforceable by each Indemnitee, its successors, endorsees, and assigns (including any entity to which the Lender assigns or sells all or any portion of its interest in the Loan). Any married person executing this Indemnity agrees that recourse may be had against community assets and against such person's separate property for the satisfaction of all obligations. As used in this Indemnity, the singular shall include the plural and the masculine shall include the feminine and neuter and vice versa, if the context so requires. If this Indemnity is executed by more than one person or entity, the liability of each such person and entity shall be the joint and several obligations of each of them.

9. *Governing Law*. This Indemnity shall be governed and construed in accordance with the internal laws of the State of _ _[*name of state*]_ _ (without reference to _ _[*name of same state*]_ _'s conflicts of law principles).

10. *CHOICE OF FORUM*. AS A SPECIFICALLY BARGAINED INDUCEMENT FOR LENDER TO EXTEND CREDIT TO INDEMNITOR, INDEMNITOR AGREES THAT ANY ACTION, SUIT, OR PROCEEDING IN RESPECT OF OR ARISING OUT OF THIS INDEMNITY, ITS VALIDITY, OR PERFORMANCE, WITHOUT LIMITATION ON THE ABILITY OF LENDER, ITS SUCCESSORS AND ASSIGNS, TO INITIATE AND PROSECUTE IN ANY APPLICABLE JURISDICTION ACTIONS RELATED TO THE ENFORCEMENT OF THIS INDEMNITY, MAY BE INITIATED AND PROSECUTED AS TO ALL PARTIES AND THEIR SUCCESSORS AND ASSIGNS. LENDER AND INDEMNITOR EACH CONSENTS TO AND SUBMITS TO THE EXERCISE OF JURISDICTION OVER ITS PERSON BY ANY STATE COURT SITTING IN THE CITY OR COUNTY OF _ _[*name of county and state*]_ _ OR ANY UNITED STATES OF AMERICA COURT SITTING IN _ _[*name of state or federal district in state*]_ _ HAVING JURISDICTION OVER THE SUBJECT MATTER AND EACH CONSENTS THAT ALL SERVICE OF PROCESS BE MADE BY CERTIFIED MAIL DIRECTED TO INDEMNITOR AND LENDER AT THEIR RESPECTIVE ADDRESSES AS SET FORTH BELOW (OR SUCH OTHER ADDRESS AS A PARTY MAY FROM TIME TO TIME DESIGNATE FOR ITSELF BY NOTICE TO THE OTHER PARTY) OR AS OTHERWISE PROVIDED UNDER THE LAWS OF THE STATE OF _ _[*name of state*]_ _. INDEMNITOR WAIVES ANY OBJECTION BASED ON *FORUM NON CONVENIENS,* AND ANY OBJECTION TO VENUE OF ANY ACTION INSTITUTED UNDER THIS INDEMNITY, AND CONSENTS TO THE GRANTING OF SUCH LEGAL OR EQUITABLE RELIEF AS IS DEEMED APPROPRIATE BY THE COURT.

11. *Provisions Severable*. Every provision of this Indemnity is intended to be severable. If any provision of this Indemnity or the application of any provision to any party or circumstance is declared to be illegal, invalid, or unenforceable for any reason by a court of competent jurisdiction, such invalidity shall not affect the balance of the terms and provisions of this Indemnity or the application of the provision in question to any other party or circumstance, all of which shall continue in full force and effect.

12. *No Waiver*. No failure or delay on the part of any Indemnitee to exercise any power, right, or privilege

under this Indemnity shall impair any such power, right, or privilege, or be construed to be a waiver of any default or an acquiescence in such failure or delay, nor shall any single or partial exercise of such power, right, or privilege preclude other or further exercise of that or any other right, power, or privilege. No provision of this Indemnity may be changed, waived, discharged, or terminated except by an instrument in writing signed by the party against whom enforcement of the change, waiver, discharge, or termination is sought.

13. *Counterparts; Paragraph Captions*. This Indemnity may be executed in any number of counterparts, each of which shall be deemed an original and all of which shall constitute one and the same Indemnity with the same effect as if all parties had signed the same signature page. Any signature page of this Indemnity may be detached from any counterpart of this Indemnity and reattached to any other counterpart of this Indemnity identical in form but having attached to it one or more additional signature pages. Captions in paragraphs are included for convenience only. They are not to be utilized in interpreting this Indemnity.

14. *Confirmation of Authority*. The Indemnitor (and their representatives, executing below) have full power, authority, and legal right to execute this Indemnity and to perform all of their obligations under this Indemnity.

15. *Merger*. All prior understandings, representations, and agreements with respect to this Indemnity are merged into this Indemnity, which alone fully and completely expresses the agreement of the parties.

16. *Secured*. As stated in the Deed of Trust, Indemnitor's obligations under this Indemnity are secured by the Deed of Trust.

17. *WAIVER OF JURY TRIAL*. AS A SPECIFICALLY BARGAINED INDUCEMENT FOR LENDER TO ENTER INTO THE LOAN AGREEMENT AND EXTEND CREDIT TO INDEMNITOR, TO THE FULLEST EXTENT NOW OR HEREAFTER PERMITTED BY LAW, INDEMNITOR AND LENDER EACH WAIVES TRIAL BY JURY WITH RESPECT TO ANY ACTION, CLAIM, SUIT, OR PROCEEDING IN RESPECT OF OR ARISING OUT OF THIS INDEMNITY OR THE CONDUCT OF THE RELATIONSHIP BETWEEN LENDER AND INDEMNITOR.

INDEMNITOR

_____,

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California LLC*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

EXHIBIT A

Real Property Description

Comment: Section 2 of this form contains warranties and representations by the indemnitor. Frequently, borrowers attempt to limit their representation and warranty to the "best knowledge and belief" of specified officers or employees of borrower or otherwise define the scope of their inquiry, but this is strongly resisted by lenders who do not want the risk of unknown matters shifted to them.

Section 16 makes this form a secured environmental indemnity, and the deed of trust should contain a statement that it secures the environmental indemnity. The environmental provisions of the deed of trust and the environmental indemnity should be made consistent. If the lender wishes the environmental indemnity to be unsecured, Section 16 must be deleted, and clear statements should be added to both the environmental indemnity and the deed of trust confirming that the environmental indemnity is not secured by the deed of trust. Lender's counsel should also then consider excluding environmental obligations from the deed of trust to avoid the inconsistency of secured environmental obligations in the deed of trust while the same obligations in the unsecured environmental indemnity are stated to be unsecured.

PRACTICE TIP: The jury trial waiver is intentionally in boldface type and placed just before the indemnitor's signature to increase the likelihood that it will be enforced, to the extent that it is enforceable. Predispute waivers of jury trial

are not currently enforceable under California law (see *Grafton Partners LP v Superior Court* (2005) 36 C4th 944, 32 CR3d 5), unless coupled with an agreement to arbitrate disputes or for judicial reference of disputes. For discussion of the enforceability of jury trial waivers, see §4.58. For forms of waiver and alternative dispute resolution clauses, see §4.115. For drafting strategies, see §§3.103, 4.58, 6.88.

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6

The Guaranty

Peter S. Muñoz
Michael A. Kvarme

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I. INTRODUCTION

§6.1 A. Scope and Limit of Chapter

This chapter deals with guaranties in the context of common real estate financing transactions. It discusses the reasons for obtaining a guaranty, the crucial elements of a guaranty, how a guaranty is distinguished from other financial accommodations, provisions commonly included in guaranties, and why they are included. It also includes a form of guaranty for a typical real estate financing transaction.

This chapter does not address more sophisticated guaranties that may be used in personal property or mixed collateral financing (personal property and real property), and it only briefly discusses guaranties that support performance of obligations not simply requiring payment of money, such as "completion guaranties" and "lease guaranties." On lease guaranties, see Retail Leasing: Drafting and Negotiating the Lease, chap 42 (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease, chap 46 (Cal CEB 1996).

For general guidance on suretyship issues, see Restatement (Third) of Suretyship and Guaranty (1996). This revised Restatement retains much of the material of the Restatement of Surety (1941).

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§6.2 B. Nature of Guaranty

A guarantor is one who promises to answer for the debt, default, or miscarriage of another, or one who hypothecates property as security for another. CC §2787. In California, before 1939 there was a legal distinction between a "guaranty" and a "suretyship," but those distinctions were eliminated in 1939 and the terms are now interchangeable. For further discussion of guaranties and sureties, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009). See generally Arnold, *"Guaranties of Indebtedness" Under California Law: Issues in Drafting and Enforcement,* 1 Cal Real Prop J 1 (Spring 1983).

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§6.3 1. Terminology

To avoid confusion, all parties to the guaranty transaction should understand the common terms used in a guaranty relationship. The party obligated under the guaranty is the "guarantor" or "surety." The party benefited by the guaranty is often referred to as the "beneficiary," "creditor," or "lender." The guaranteed obligation is often known as the "primary obligation," "primary debt," or "principal debt." The party who is obligated under the "primary obligation" is the "borrower," "primary obligor," "principal debtor," or simply a "principal."

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§6.4 2. Separate Obligation

A guaranty creates a contractual obligation of the guarantor that is separate and distinct from the obligations of the primary obligor. Because of this distinction, the courts have recognized that one person cannot be both a guarantor and a primary obligor of the same debt. See §§6.38, 6.44.

This fact has a significant impact on the applicability of the antideficiency laws to a general partner's purported guaranty of a partnership obligation (see §§6.39-6.43) or to a party's purported guaranty of an obligation of the guarantor's alter ego (see §6.44).

PRACTICE TIP: Because of this distinction, it is important that the creditor conduct due diligence to confirm the precise legal relationship between the primary obligor and the contemplated guarantor (see form representations and warranties in §6.84), and that the creditor not dictate the structure of or relationship between the guarantor and the primary obligors. See, *e.g., River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790, discussed in §6.44; *Union Bank v Brummell* (1969) 269 CA2d 836, 75 CR 234.

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§6.5 3. Third Party Collateral

In many real estate financing transactions, a lender receives a lien on collateral not owned by the borrower. Banks customarily refer to these as "third party collateral" or "lent collateral" arrangements. It is important to note that in this situation the party who puts up the collateral (whether real or personal property) is considered to be a "guarantor" and, unless effectively waived, is entitled to all rights and protections provided for guarantors. The full extent of such a "guarantor's" liability is limited to the posted collateral. As a result, the document used to encumber the assets not belonging to the borrower should be considered a guaranty and should either secure a guaranty of the underlying debt or be modified to include all customary guaranty-type provisions.

PRACTICE TIP: When a party other than the borrower provides a deed of trust to secure the borrower's obligations, there should be an addendum to the deed of trust or a separate document waiving all suretyship defenses and rights. See §§4.122, 6.77-6.79.

If the collateral is provided by a nonborrower third party, the lender should consider alternative structures for the financing transaction. Instead of having the real property secure the loan, the lender may wish to have the third party sign a guaranty and have the collateral secure the guaranty. In this fashion, the primary obligation would be free of the one-action rule and antideficiency protections discussed in §§6.32-6.37 (assuming that there is no other real property collateral) and the lender would have more leeway to take action against the primary obligor while retaining a lien on the real property to secure the guaranty.

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§6.6 4. Commercial Code Classification

Commercial Code Division 9, which governs security interests in personal property, makes the following classification of parties:

- The "debtor" is typically the party who owns (or has some other nonlien interest in) the personal property collateral. Com C §9102(a)(28)(A).
- An "obligor" is a party who owes payment or performance of the secured obligation, has provided real property collateral or other personal property collateral not subject to Division 9 of the Commercial Code to secure the obligation, or is otherwise accountable for payment or performance of the obligation. Com C §9102(a)(59).
- A "secondary obligor" is an obligor whose obligation is secondary, or who has a right of recourse against the debtor, another obligor, or property of either. Com C §9102(a)(71).

In this classification, a guarantor of payment or performance is a secondary obligor. The enforcement provisions of Division 9 make it clear that, as a secondary obligor, a guarantor is entitled to the same protection as the debtor. These protections include the following:

- The debtor and any secondary obligor must receive proper advance notice of the disposition of any collateral (Com C §9611(c));
- All collateral must be disposed of in a commercially reasonable manner (Com C §9601(b));
- All proceeds of collateral must be properly applied to the secured obligation (Com C §9623(a)).

The right to notice and the right to redeem cannot be waived in advance. Com C §9624(a), (c). The secured creditor's duty to dispose of collateral in a commercially reasonable manner cannot be waived at all. Com C §9602. (Compare the enforceable waivers of other guarantor protections discussed in §§6.46-6.60.)

A third party who pledges personal property collateral to secure the underlying debt is both a "surety" under CC §2787 and a "debtor" under Com C §9102(a)(28)(A). A third party that pledges only real property to secure the underlying debt is also a surety under CC §2787 and is an "obligor" under Com C §9102(a)(59).

Thus, when the underlying obligation is secured by personal property collateral (with or without real property collateral), the guarantor will have the benefit of these Division 9 protections.

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§6.7 C. Distinguishing Guaranty From Similar Financial Accommodations

The statutory definition of a guaranty (see CC §2787)—a promise to answer for another or a pledge of collateral for another's obligation—is intentionally broad in its scope. Other financial accommodations, however, are also commonly used, which achieve virtually the same objective as a guaranty but that are distinct from guaranties in their form and their legal effect. All parties to a proposed guaranty transaction should be aware of those distinctions and should consider the other accommodations as viable alternatives, but should be careful not to confuse one with another.

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§6.8 1. Indemnity Agreements

Many guaranties contain indemnification language, and a "guaranty" is often confused with an "indemnity." But the terms are not interchangeable: An indemnity is a contract by which one party (the "indemnitor") agrees to hold another party (the "indemnitee") harmless from the consequences of the conduct of one of the parties or of a third person. CC §2772. A guaranty creates a duty on the part of the guarantor to perform the obligation of another, without regard to the degree of harm suffered by the lender on the primary obligor's default. For example, an insurance policy is a type of indemnity agreement.

Several statutory rights and obligations are imposed on an indemnitor that are similar to those imposed on a guarantor. See CC §§2772-2784.5. Although an indemnitor's obligations and rights are often similar to those of a guarantor, they are not identical. Loan transactions typically involve guarantees, environmental indemnities (which are subject to special rules; see chap 5A), and "bad boy" indemnities, covering acts such as misappropriation of funds. Each type of provision needs to be prepared or reviewed in light of its respective governing rules.

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§6.9 2. Letters of Credit

Many real estate financings use letters of credit (whether from banks or from private individuals and entities); and such financial accommodations are often misunderstood to be the equivalent of a guaranty.

A letter of credit is a written commitment issued by a bank or another party to advance funds on the delivery of certain documents (documentary letter of credit) or on the occurrence of certain events (standby letter of credit). The commitment must be in writing but consideration is not required. Com C §5105.

A standby letter of credit is often used instead of a guaranty in real estate lending situations. In its simplest form, it permits the beneficiary of the letter of credit (the lender) to make a demand for payment (a draw) on the letter of credit by presenting to the issuer a statement that the obligation owed to the lender remains owing and unpaid. If a standby letter of credit is issued in connection with a promissory note, the commitment under the letter of credit is not a guaranty; it is entirely independent of the obligation under the note. CC §2787; *Western Sec. Bank v Superior Court* (1997) 15 C4th 232, 246, 62 CR2d 243. Any defense to payment on the note cannot be used to stop payment on the letter of credit. In fact, there are very few grounds that could be used to prevent a draw and payment under the letter of credit; which is a primary reason lenders often prefer and debtors dislike letters of credit.

When a letter of credit is issued, the rights and obligations between the issuer of the letter of credit and the party for whom the letter of credit is issued are specified in a separate agreement

For discussion of the factors differentiating letters of credit, indemnities, and guaranties, see Restatement (Third) of Suretyship and Guaranty §1 (1996).

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§6.10 3. Note Purchase Agreements

In some financing transactions, a third party agrees to purchase the underlying promissory note on the lender's demand if there is a default under the note. Such a financial accommodation is arguably not a "guaranty," because the third party is not promising to pay or to perform the borrower's obligations under the note. Instead, for an agreed price, the third party commits to acquire the defaulted obligation and to step into the lender's position. Whether such an interpretation will be upheld or whether a court would view an obligation to purchase a promissory note on the occurrence of an event of default as a promise "to answer the debt, default, or miscarriage of another" within the meaning of CC §2787 remains a significant issue.

PRACTICE TIP: A party reviewing or drafting a note purchase agreement should remember that courts do not allow form to control over substance. A note purchase agreement that contains the basic elements of a guaranty is treated as a guaranty regardless of its ostensible title.

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§6.11 D. Reasons for Selecting Guaranty Arrangement

A guaranty arrangement is often selected instead of another form of financial accommodation for a variety of reasons. First, it is customary and familiar to all parties. Second, although a lender might prefer a letter of credit, the party providing the financial accommodation usually prefers to sign a guaranty rather than provide a letter of credit because the issuer of a letter of credit has few defenses and protections, and it is often expensive to obtain a letter of credit from a financially viable institution. Third, a purchaser under a note purchase agreement often insists on a discount the lender does not want to grant. Finally, by putting the guarantor's assets at risk, the lender receives comfort that the guarantor believes in the financial soundness of a particular project or property.

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II. LEGAL AND PRACTICAL CONSIDERATIONS

§6.12 A. Creation of Guaranty Relationship

The requirements for an enforceable guaranty are minimal. Generally, the guarantor must sign a written agreement that specifies the obligation being guaranteed. See §6.13. The lender must give consideration or act in reliance on the guaranty. Little else is required for an enforceable guaranty. See §6.14. The primary obligor's consent or knowledge is not necessary. CC §2788.

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§6.13 1. Writing

A guaranty must usually be in writing, although the written agreement need not specify the consideration received. CC §2793. There are only six narrow exceptions (dealing with circumstances in which the obligation is "deemed an original obligation of the promisor") to this requirement, which are set forth in CC §2794. See §6.14 on the effectiveness of an oral guaranty to support a later-executed document.

PRACTICE TIP: The exceptions are so narrow that a lender should as a matter of prudent practice always have the guarantor sign a written agreement.

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2. Consideration/Reliance

§6.14 a. Requirement for Enforceability

If the guaranty is executed when the primary obligation is created or accepted, the underlying obligation forms a part of the lender's consideration and no other consideration is necessary. CC §2792. Under any other circumstance, the consideration must be distinct from that of the original underlying obligation. A guaranty of an existing loan, for instance, must always be supported by consideration. The presumption set forth in CC §2792 does not apply to any guaranty of preexisting debt. *Oakland Bank of Commerce v Washington* (1970) 6 CA3d 793, 796, 86 CR 276. No recitals of consideration in the guaranty, however, are required in either situation. CC §2793.

Guarantors who seek to avoid liability often litigate the question of whether there was consideration by arguing that their guaranties were executed after the primary obligation. Courts have generally avoided these defenses when (1) a prior oral promise to guarantee was made and a written guaranty was subsequently executed (see *Pacific States Sav. & Loan Co. v Stowell* (1935) 7 CA2d 280, 46 P2d 780), or (2) the primary obligation and the guaranty were given as part of a single transaction regardless of when the documents were signed (see *Beverly Hills Nat'l Bank v Glynn* (1968) 267 CA2d 859, 73 CR 808; *Citizens Trust & Sav. Bank v Bryant* (1921) 53 CA 735, 200 P 823). See generally Arnold, *"Guaranties of Indebtedness" Under California Law: Issues in Drafting and Enforcement*, 1 Cal Real Prop J 1, 18-19 (Spring 1983).

PRACTICE TIP: To avoid any argument about consideration, the guaranty should recite that the lender enters into the transaction in reliance on the guaranty. The guaranty should also recite the guarantor's receipt of consideration because it helps the lender satisfy its burden of proof if there is litigation to enforce the guaranty. For a form reciting consideration, see §6.69.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.15 b. Fraudulent Transfer Issues

§6.15 b. Fraudulent Transfer Issues

Even though CC §2792 states that no additional consideration is needed to make a guaranty enforceable, lender's counsel must consider the possible application of the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439.01-3439.12). Under UFTA, a creditor may avoid a transfer of assets or a contractual obligation made by its debtor when the debtor-transferor/obligor is insolvent or is made insolvent or is left with insufficient capital to conduct its business because of the transaction, *unless* the transferor/obligor has received reasonably equivalent value in connection with the transaction. The parties' intent is irrelevant. Thus. a creditor of a purported guarantor may be able to void the guaranty if the guarantor did not receive reasonably equivalent value in consideration for executing the guaranty.

PRACTICE TIP: Generally, counsel should advise clients to perform financial analysis and valuation regarding fraudulent transfer issues.

A particularly troublesome problem with guaranties arises with those given by a corporation for debts of its shareholders (including guaranties by a subsidiary of the debt of its parent, called "upstream guaranties" and cross-guaranties given by corporations under the common control of a single parent (called "side-stream guaranties"). The type and quantity of consideration that must be given to an upstream or a side-stream guarantor to satisfy the "reasonably equivalent value" requirement are unresolved issues under UFTA. For discussion of this and related issues, see Power & Hanrahan, *The California Uniform Fraudulent Transfer Act*, 8 CEB Cal Bus L Rep 189 (Mar. 1987). On the UFTA generally, see Debt Collection Practice in California §§12.66, 13.32 (2d ed Cal CEB 1999).

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§6.16 3. Scope of Guaranty

Anyone drafting or reviewing a guaranty must pay particular attention to the scope of the underlying obligation. The rules of contract interpretation applicable to guaranties generally favor the guarantor. Any ambiguity in the documents is often resolved in the guarantor's favor. See *Pearl v General Motors Acceptance Corp.* (1993) 13 CA4th 1023, 16 CR2d 805.

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a. Payment Versus Performance

§6.17 (1) Distinction

The distinction between a payment guaranty and a performance guaranty is extremely important to the guarantor and is frequently overlooked. In the loan context, the guarantor normally understands that its ultimate liability is payment of the note, *i.e.,* a payment guaranty, not performance of all other monetary and nonmonetary covenants in the deed of trust and other loan documents. The ultimate liability may equal the same monetary amount under a payment guaranty and performance guaranty; but in the performance guaranty context the lender may have extraordinary remedial rights against a guarantor, especially if a construction loan is involved when completion of the structure is at stake. See §6.18. In any loan setting, however, liabilities in matters such as toxics, representations, or breach of covenants could cause liability to accrue that exceeds the face amount of the debt. For a form payment and performance bond provision, which clearly state the intentions of the parties regarding payment and performance, see §§6.69, 6.71.

PRACTICE TIP: When the loan documents required the borrower to comply with all environmental laws and correct any environmental violations, the guarantor might be required to step in and correct any environmental problems with the underlying real property. This in turn could impose further liability on the guarantor as a "controlling party" under state and federal environmental laws. If the guarantor wants to limit its exposure, it may want to include language in the guaranty allowing it to simply pay off the loan rather than perform any environmental remediation. See §6.20.

On environmental indemnity generally, see chap 5A. For further discussion of payment and performance bonds, see California Mechanics' Liens and Related Construction Remedies, chap 10 (3d ed Cal CEB 1998).

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§6.18 (2) Completion Guaranty

If a construction loan is involved in a transaction, a guarantor is often required to execute a completion guaranty, guaranteeing the borrower's compliance with a building loan agreement, a key provision of which is completing the project in accordance with the approved plans and specifications. See §9.7. Although a form of completion guaranty is not included in this chapter, many of the provisions of a completion guaranty are similar to those in the guaranty form in §§6.68-6.73.

In connection with completion guaranties, practitioners should be aware of *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135 CR 802, which limits a lender's recovery under a completion guaranty to the amount by which failure to complete the improvements has impaired the lender's security. That amount is measured by the difference between the value of the project with and without the promised improvements. This recovery is presumably limited by the unpaid balance of the loan. See California Construction Contracts, Defects, and Litigation §11.16 (Cal CEB 2008).

NOTE: This measure of damages may impose a significant limitation on the amount recoverable by a lender as damages if the loan is undersecured.

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§6.19 b. Payment Versus Collection

The distinction between a guaranty of payment and a guaranty of collection or collectibility is also extremely important. A guaranty of payment does not require the lender to attempt collection against the primary obligor before proceeding against the guarantor. A guaranty of collection merely promises the lender that the primary obligation is collectible from the borrower by the usual legal proceedings. CC §2800. Under a guaranty of collectibility, the lender must usually attempt to collect the primary obligation from the primary obligor and to exhaust its collection remedies before making a demand on the guarantor. CC §2801. If the primary obligor has left California and has no California property that could be used to satisfy the primary obligation, then the primary obligor is considered insolvent and the lender may make a demand under the guaranty. CC §2802.

Obviously, a guaranty of collection is more difficult for the lender to enforce in a prompt manner than is a guaranty of payment. As a result, it is common for the guaranty to clearly state whether it is a guaranty of payment or a guaranty of collection. See §6.71.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.20 c. Obligation Guarantied

§6.20 c. Obligation Guarantied

One of the most important items in a guaranty is the description of the obligation being guarantied. The creditor must be careful in defining the obligation because any limitation is interpreted liberally in the guarantor's favor. For example, if the guaranty is intended to cover a promissory note and a loan agreement, the document should guarantee *payment* of all amounts owed *and performance* of all obligations under the note and the loan agreement. See §§6.17-6.19.

DRAFTING CONSIDERATIONS: As a rule, the guaranty should not list the specific obligations and payments already listed in the agreements guaranteed. For example, the guaranty should not repeat all the payment terms of the promissory note, because any inconsistency in the guaranty would be interpreted as limiting its scope. Instead, the guaranty should accurately describe the *documents* detailing the guaranteed obligation and incorporate their terms by reference.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.21 d. Continuing Guaranties

§6.21 d. Continuing Guaranties

A continuing guaranty is a guaranty of the present and future liability of the principal debtor in subsequent transactions. CC §2814. A continuing guaranty may be revoked at any time, and the revocation is effective for transactions occurring after the revocation. CC §2815. Revocation of the continuing guaranty, however, does not terminate the guarantor's liability for the primary obligations that arose or were made before the revocation.

NOTE: Terminating a continuing guaranty often constitutes an event of default under the loan documents.

Continuing guaranties are more common in commercial loans and lines of credit when the lender and borrower expect a long-term relationship involving a series of advances, draws, or other transactions. They are sometimes used in real estate loan transactions.

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§6.22 e. Maximum Liability

In guaranty transactions, guarantors and lenders often agree on the guarantors' maximum liability or, for multiple guarantors, maximum liability either in the aggregate or individually. It is important that the parties clearly define any intended limits on the guarantors' liabilities. For example, if a party guarantees payment of $1,000,000 on a $2,500,000 promissory note, the question arises whether the guarantor will also be liable if the note is paid down to $500,000 before a default and whether the guarantor will be liable for paying interest and attorney fees. See discussion in §6.29. Clarifying these issues benefits both the guarantor, by delineating the extent of liability, and the lender, by avoiding any confusion that might be interpreted in the guarantor's favor. It is generally prudent practice for a limited guaranty to contain all standard provisions stating that the guarantor will be liable for the entire obligation, subject to a maximum amount. See §6.75.

There is a second benefit to the lender from a limitation on liability: As discussed in §6.15, a guaranty may be voidable as a fraudulent transfer. Putting a dollar cap on the guaranty (if adjusted to comport with the guarantor's liquidity) prevents a fraudulent transfer challenge because the guarantor is not rendered insolvent by executing the guaranty.

See §6.29 on the application of partial payments, which is particularly significant when only a portion of the principal debt is guaranteed.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.23 f. Attorney Fees

§6.23 f. Attorney Fees

When negotiating the guaranty, the creditor and guarantor must consider the issue of attorney fees from two perspectives: (1) attorney fees that may be incurred by the creditor in enforcing the primary obligation, and (2) attorney fees that may be incurred by the creditor in enforcing the guaranty. Generally, the creditor insists on recovering all attorney fees, however incurred. Courts will enforce such provisions if they are clear. For form, see §6.95.

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§6.24 (1) State Law

California law provides that reasonable attorney fees are recoverable when provided by written agreement. CC §1717(a). Costs are a separate element and not included in the attorney fee category. *Hsu v Semiconductor Sys., Inc.* (2005) 126 CA4th 1330, 25 CR3d 82. See also *Fairchild v Park* (2001) 90 CA4th 919, 109 CR2d 442; *California Hous. Fin. Agency v E.R. Fairway Assocs. I* (1995) 37 CA4th 1508, 44 CR2d 591; *Ripley v Pappadopoulos* (1994) 23 CA4th 1616, 28 CR2d 878. Also, in *Arntz Contracting Co. v St. Paul Fire & Marine Ins. Co.* (1996) 47 CA4th 464, 54 CR2d 888, the court commented that it may be appropriate to limit a general contractual cost provision to an established statutory cost definition (see, *e.g.,* CCP §§1032, 1033, 1033.5), but that there is no reason to prevent "sophisticated parties from freely choosing a broader standard authorizing recovery of reasonable litigation charges and expenses." 47 CA4th at 492. Recovery of costs more broadly defined in the contract must be specially pleaded and proven at trial, and not awarded in posttrial attorney fee motions. 47 CA4th at 491.

PRACTICE TIP: Counsel drafting and reviewing attorney fee provisions should be familiar with the California Supreme Court decision in *Santisas v Goodin* (1998) 17 C4th 599, 71 CR2d 830, which permits the enforcement of a contract clause providing for recovery of attorney fees to the prevailing party on tort (but not contract) claims when the plaintiff dismisses the action before judgment. *Santisas* has given contracting parties considerably more discretion to broadly define "prevailing party," but only as that term applies to tort actions addressed in the contract.

Unless the attorney fee clause (or other section of the loan documents) expressly provides for recovery of attorney fees in an action for waste brought by the lender under a nonrecourse carveout, attorney fees in such an action are not recoverable. See *Aozora Bank, Ltd. v 1333 North Cal. Blvd.* (2004) 119 CA4th 1291, 15 CR3d 340, discussed in §4.66.

For further discussion of attorney fees, see California Attorney Fee Awards (2d ed Cal CEB 1994).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.25 (2) Federal Bankruptcy Law

§6.25 (2) Federal Bankruptcy Law

Until recently there was uncertainty as to what language must be included in a document to allow the lender to recover its attorney fees from a bankrupt entity. A secured creditor's right to recover attorney fees in a bankruptcy proceeding was clarified in *In re Kord Enters. II (Kord Enters. II v California Commerce Bank)* (9th Cir 1998) 139 F3d 684. The court held that, under 11 USC §506(b) as a matter of *federal* law in a bankruptcy, the secured creditor is entitled to recover attorney fees if

- the claim is an allowed secured claim;
- the creditor is oversecured (*i.e.,* the value of the collateral exceeds the value of the security);
- the fees are reasonable; and
- the right to recover fees is set forth in the agreement under which the claim arose.

The court held that even a broad statement of a right to recover fees was sufficient. It was enough if the contract provided for fees incurred in "bankruptcy proceedings." 139 F3d at 689. In 2005, Congress expanded the fourth element of the *Kord Enters.* rule by amending §506(b) to state that "reasonable fees are allowable only when they are provided for under the agreement or State statute under which such claim arose." *In re Astle* (Bankr D Idaho 2007) 364 BR 735, 741.

In 2007, the United States Supreme Court held that postpetition attorney fees are allowed as a general unsecured claim under 11 USC §502(b) if authorized by a prepetition contract. *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199.

See §6.95 for a form provision for attorney fees.

This limitation on recovery of attorney fees, however, applies only for the benefit of the bankruptcy debtor, so it would not benefit a nonbankrupt guarantor. Even though an undersecured creditor could not recover its fees from the bankrupt borrower/debtor, the bankruptcy law does not prevent the creditor from seeking to collect the attorney fees incurred in the bankruptcy from the debtor's guarantors, as long as the guaranty or the loan documents allowed for recovery of these fees.

Of course, if the guarantor filed for bankruptcy and the guaranty was unsecured or undersecured, the lender's ability to collect its attorney fees would again be limited by federal bankruptcy laws.

For further discussion, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 11 (4th ed Cal CEB 2009).

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§6.26 B. Rights, Protections, and Liabilities of Guarantors

A guarantor is not directly entitled to the benefit of defenses available to the primary debtor, because a guaranty creates an obligation separate and distinct from the primary obligation. But statutes and case law have created several defenses for guarantors, provided certain rights to guarantors, and imposed certain limitations on their liability. There are many situations in which the guarantor indirectly obtains the benefit of the defenses unless they are waived (as they routinely are in well-drafted guaranties). See §§6.46-6.60.

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§6.27 1. Guarantor Rights

The Civil Code provides the guarantor with certain rights that, unless waived, limit the lender. These are the following:

Creditor pursuit of principal debtor:

- A guarantor may require the creditor to proceed first against the principal debtor (CC §2845) or to pursue any collateral provided by the principal debtor (CC §2850) before enforcing the guaranty.

Guarantor's direct rights against principal debtor:

- A guarantor may compel the principal debtor to pay the primary debt. CC §2846.
- If the guarantor satisfies the primary debt in whole or in part (either directly or from assets that were pledged as collateral), the principal debtor must reimburse the guarantor for the amounts paid by the guarantor. CC §2847.

Guarantor's rights of subrogation:

- On satisfying the primary debt in full, the guarantor is subrogated to, or acquires, all rights of the creditor against the principal debtor.
- The guarantor can compel all coguarantors to contribute their prorata share (CC §2848) and is entitled to the benefit of all collateral held by the creditor (CC §2849).
- If, however, the creditor has released certain rights against any party or any collateral or if the creditor's actions have provided the principal borrower with defenses to further liability on the primary debt, the guarantor's rights through subrogation under CC §§2848-2849 are similarly limited.

NOTE: As discussed in §§6.46-6.60, these rights are commonly waived in the guaranty. For forms of waivers, see §§6.77-6.79.

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2. Guarantor Protections

§6.28 a. Limitation on Extent of Liability

Various protections for the guarantor are found in CC §2808, which provides that the obligation of the surety/guarantor must not be larger or more burdensome than the obligation of the primary obligor. If the guarantor's obligation is larger or more burdensome, it must be reduced in proportion to the principal obligation. CC §2809.

If the primary obligor has a defense to the principal obligation (other than personal disability), the guarantor may not be liable on the guaranty. CC §2810.

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§6.29 b. Benefit of Any Form of Payment

California statutes provide that, if a creditor accepts anything in partial satisfaction of the guaranteed obligation, the surety's obligation is reduced to the same extent unless that right has been waived. However, the primary debtor (not the guarantor) is entitled to designate which portion of the underlying obligation is satisfied. CC §2822(a). Section 2822(a) is particularly significant when a guarantor is liable on only a portion of the principal debt. See §6.22.

If a partial payment by someone other than the guarantor is made on a loan that is subject to a guaranty with an initial maximum liability, the question arises whether the payment will be applied to reduce the maximum liability or whether the guarantor's maximum liability will remained unchanged. A literal reading of CC §2819 may support the former. It is thus important for the lender that the guaranty clarify this issue at the outset. Moreover, if a guarantor makes a payment on a loan subject to a partial guaranty, the guarantor should clarify whether that payment will be applied to reduce the maximum amount of the guaranty.

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§6.30 c. Alteration of Debt or Creditor Remedies

A guarantor is exonerated (*i.e.,* released of liability under the guaranty) if, without the guarantor's consent, the creditor alters, impairs, discharges, or suspends in any respect the creditor's rights and remedies against the primary obligor. CC §2819.

Recognizing that partial debt writedowns are common occurrences, and that such writedowns benefit the surety as well as the principal debtor, the legislature amended CC §§2819 and 2822 to provide that an agreement by a creditor to accept from the principal debtor a sum less than that owed on the original obligation, without the consent of the surety and without any other change in the underlying agreement between the creditor and the principal debtor, does not exonerate the surety from liability for the debt.

The extension of additional credit alters the original obligation for purposes of CC §2819. *Shuey v Bunney* (1935) 4 CA2d 408, 40 P2d 859. Consent to alterations may be given in advance of the alteration, however; and when alterations are made with the guarantor's consent, they do not exonerate the guarantor from liability. *Bloom v Bender* (1957) 48 C2d 793, 313 P2d 568.

It is common for an obligation that is subject to a guaranty to be restructured or discharged in bankruptcy, which might result in an exoneration of the guarantor. Courts have held that, if a creditor consents to the discharge of a guaranteed promissory note and its replacement with a new note, the creditor has effectively released the guarantor unless the guarantor consented to remain liable. See discussion and cases cited in *FM Conner v Conner* (1999) 76 CA4th 646, 90 CR2d 687. In *Conner*, however, the guarantor continued to be liable because the guarantor had cooperated and had supported the reorganization plan to release the note.

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§6.31 d. Disclosure of Crucial Information

A creditor who accepts a continuing guaranty owes a duty to the guarantor to disclose facts to the guarantor if the creditor has reason to believe that the facts materially increase the risk beyond that which the guarantor intended to assume. *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564. If the creditor fails to disclose crucial information, the guarantor is exonerated of further liability on the guaranty. As a rule, this right to receive information is expressly waived (for form, see paragraph _.2.9. in §6.79), with the guarantor's acknowledgment that it is in a position to monitor the debtor and there is no need for the lender's disclosure (for form, see §6.85).

NOTE: To a significant degree, the duty of disclosure under *Sumitomo* arises under the "covenant of good faith and fair dealing" implied in all California contracts. As a result, the duty is probably not waivable. The contractual waivers, therefore, seek to eliminate the factual predicates giving rise to the duty rather than waiving the duty of disclosure itself.

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§6.31A e. Misrepresentation and Fraud

The guarantor may also use fraud statutes as a defense against liability under a guaranty. For instance, in *Pacific State Bank v Greene* (2003) 110 CA4th 375, 1 CR3d 739, a guarantor signed a personal guaranty for "all of borrower's liabilities," which covered four separate loans. The guarantor claimed that her guaranty was obtained by fraud and misrepresentation, having been told by a bank employee that she was guaranteeing only one of the loans. The court rejected the bank's invocation of the parol evidence rule, finding that the bank employee's statement was a misrepresentation of fact and not a fraudulent promise.

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3. Guarantors and the One-Action Rule

§6.32 a. Code of Civil Procedure §726 Generally Not Applicable to Guarantors

Code of Civil Procedure §726 sets forth what is commonly known as the "one-action rule." It is one of the most significant protections available to a borrower in a real-property-secured loan transaction. The rule provides that there is only one form of judicial action for the recovery of a debt secured by real property—that action being foreclosure. The rule has been interpreted as incorporating a "security first" or "collateral first" rule, which requires a real property secured lender to proceed first against its collateral before proceeding to collect against the debtor or the debtor's noncollateral assets. If the creditor files suit against the debtor to collect the note and fails to include a cause of action to foreclose on its real property collateral, the borrower can assert the one-action rule as an affirmative defense to an action on the note and can compel the creditor to foreclose on the real property collateral. If the debtor does not assert the affirmative defense and the creditor obtains a money judgment on the note, the creditor loses its security interest in the real property. *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201. This is true regardless of whether the real estate collateral belongs to the principal debtor or whether it belongs to a third party and is pledged to secure the note. See *Pacific Valley Bank v Schwenke* (1987) 189 CA3d 134, 234 CR 298.

Case law, however, holds that the limitations imposed by the one-action rule exist for the borrower's protection and do not apply to guarantors, because the guarantor's obligation is separate and distinct from the obligation secured by the real property (*i.e.,* the principal debtor's primary obligation under the note). *Kirkpatrick v WestAmerica Bank* (1998) 65 CA4th 982, 76 CR2d 876. The one-action rule, therefore, does not prevent the secured creditor from ignoring the real property collateral and proceeding first against the guarantor in a separate action (unless, of course, the guaranty is itself directly secured by real property).

WARNING: Including the guarantor as a party defendant in a judicial foreclosure action is probably necessary for a deficiency judgment to be awarded against the guarantor. *Titus v Woods* (1920) 45 CA 541, 188 P 68 (guarantor proper but not necessary party). Guarantors should assume that they will be named as parties to any action on the note even if the collateral has not yet been liquidated. See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4, 9 (4th ed Cal CEB 2009).

Guarantors have contended that they are indirectly entitled to the protection of CCP §726 under CC §2809 because the latter provides that a guarantor's obligations cannot be "more burdensome" than the borrower's. This contention, however, was rejected by the California Supreme Court in *Loeb v Christie* (1936) 6 C2d 416, 57 P2d 1303.

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§6.33 b. Code of Civil Procedure §726 Applies to Certain Partner Guarantors

The one-action rule of CCP §726 protects some parties who are identified as guarantors. Loan transactions sometimes have a guaranty from a person or entity that is also a general partner or alter ego of the borrower. Courts have held that a creditor is bound by the one-action rule in seeking to collect a partnership's real-estate-secured obligation from a general partner of the partnership (or from a general partner of a general partner of the partnership) because the general partner is liable for the partnership's debts. For discussion of the Revised Uniform Partnership Act (RUPA), see §6.40. If the creditor acts to collect the secured debt from the general partner or from the general partner's noncollateral assets, the lender must comply with §726. See *Prestige Ltd. Partnership-Concord v East Bay Car Wash Partners* (*In re Prestige Ltd. Partnership-Concord*) (Bankr ND Cal 1998) 223 BR 203 (*Prestige II*).

See also Seneker & Young, *General Partner Guaranties*: *Guaranteed Recovery or Frustration?*, 10 Real Prop J 3 (Summer 1992). For a comprehensive discussion of the applicability of the protection to general partners, see §§6.39-6.40.

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§6.34 4. Guarantors and the Antideficiency Statutes

The California antideficiency statutes (CCP §§580a, 580b, and 580d) make up the second major set of defenses available to a borrower in a real-estate-secured loan. These sections limit or prohibit personal judgments against borrowers when the proceeds of sale of the real property securing the underlying debt are insufficient to discharge the debt fully. Like CCP §726, however, the statutes in general protect

- the borrower, not the guarantor, and
- parties such as general partners that are jointly liable with a borrowing partnership but are designated as guarantors.

On guarantors and the antideficiency statutes, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009). For an in-depth discussion of the antideficiency statutes, see Mortgage Deed of Trust Foreclosure, chap 5.

NOTE: See discussion of purported or sham guaranties in §§6.38-6.44. For a comprehensive review of the issues relating to the enforceability of general partner guaranties in light of the one-action rule, the antideficiency rules, and partnership law, see Seneker & Young, *General Partner Guaranties*: *Guaranteed Recovery or Frustration?,* 10 Cal Real Prop J 1 (Summer 1992).

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§6.35 a. Code of Civil Procedure §580a—The "Fair Value" Rule

Code of Civil Procedure §580a provides that, when recovery is sought for a deficiency arising after a sale made under a power of sale in a deed of trust, the deficiency shall not be more than the lesser of the following:

- The amount by which the outstanding debt exceeded the fair market value of the real property; or
- The amount by which the outstanding debt exceeded the amount for which the property was sold.

For most transactions, CCP §580a has become irrelevant as a protection against deficiencies. This is because CCP §580d establishes an absolute bar to a deficiency judgment if the real property security has been sold under a power of sale instead of by judicial foreclosure. See §6.37. But as a result of *Bank of Hemet v U.S.* (9th Cir 1981) 643 F2d 661, CCP §580a may have some continued viability in limiting the amount of a deficiency judgment recoverable from the borrower by a junior lienholder who purchases property at a nonjudicial sale conducted by a senior lienholder. The *Bank of Hemet* decision distinguishes *Roseleaf Corp. v Chierighino* (1963) 59 C2d 35, 27 CR 873, in which the sold-out junior did not purchase at the senior's nonjudicial foreclosure sale.

Likewise, CCP §580a may also have continued viability for purposes of limiting deficiency judgments against guarantors. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009). Although reported California decisions have declined to apply fair value protection to guarantors, one depublished opinion granted such protection to a guarantor. See *Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 46 CR2d 656). Although *Dombrow* was ordered not to be published, it was not reversed. See §6.52 for further discussion of *Dombrow*. Cases denying protection to guarantors under CCP §580a include *Bank of America v Hunter* (1937) 8 C2d 592, 67 P2d 99, and *Security-First Nat'l Bank v Chapman* (1940) 41 CA2d 219, 106 P2d 431.

The expanded language of CC §2856, as revised effective January 1, 1997, should make it clear that any rights accorded to a guarantor under CCP §580a are waivable.

It is also conceivable that CCP §580a may *expand* the scope of a guarantor's liability for a deficiency judgment following a nonjudicial sale of real property that secures a payment guaranty. Because CCP §580d refers only to a "note" secured by real property, it is possible that the "fair value" limits of CCP §580a may constitute the only limitation upon a post-trustee-sale deficiency judgment when the guaranty itself is secured by real property. See Arnold, *"Guaranties of Indebtedness" Under California Law: Issues in Drafting and Enforcement*, 1 Cal Real Prop J 1, 21-22 (Spring 1983).

For a full discussion of the fair value rule, see Mortgage Deed of Trust Foreclosure, chaps 3, 5, 9.

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§6.36 b. Code of Civil Procedure §580b—Guarantors and the Purchase Money Limitation

Code of Civil Procedure §580b sets forth two separate situations in which a deficiency judgment is barred in purchase money transactions. First, when a purchaser executes a contract of sale, deed of trust, or mortgage in favor of the seller of property to secure payment of the purchase price of the encumbered property, there is an absolute bar on the recovery of any deficiency from the borrower. Second, in situations involving a third party lender, the bar on deficiency judgments applies when the deed of trust or mortgage given to the lender encumbers a dwelling for no more than four families occupied at least in part by the borrower and when the property is given as security for repayment of a loan that was used to pay all or part of the purchase price of the dwelling. Code of Civil Procedure §580b does not prohibit recovering a deficiency against the borrower if a third party lender advanced funds to purchase commercial property. See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 5, 9 (4th ed Cal CEB 2009) for an in-depth discussion of CCP §580b.

The California Supreme Court has not yet definitively resolved the question of whether CCP §580b protects guarantors of purchase money obligations mortgages from liability for deficiency judgments to the same extent as borrowers. Several appellate court decisions have held that §580b does not protect guarantors. None of these cases, however, has agreed on the rationale for the denial of §580b antideficiency protection to guarantors. See *Paradise Land & Cattle Co. v McWilliams Enters.* (9th Cir 1992) 959 F2d 1463 (distinguishing several California cases that extended §580b protection to guarantors on basis of common identity of borrower and guarantors, court found that guarantor did not require §580b protection, because (1) it was a corporation and thus its shareholders were protected by the central feature of corporations: "limited liability," (2) it had a long history and substantial assets, and (3) it was not a "dummy" corporation); *Roberts v Graves* (1969) 269 CA2d 410, 75 CR 130 (§580b protection denied to guarantors by analogizing guarantors to endorsers); *Heckes v Sapp* (1964) 229 CA2d 549, 40 CR 485 (policies underlying §580b are satisfied by limiting antideficiency protections to purchasers); *Katz v Haskell* (1961) 196 CA2d 144, 16 CR 453 (legislature did not intend to protect guarantors under §580b). In *Union Bank v Dorn* (1967) 254 CA2d 157, 159, 61 CR 893, however, the court notes that the question of whether guarantors are protected under §580b is "a point not entirely free from doubt."

Until the California Supreme Court eliminates any confusion generated by the courts of appeal decisions on the applicability of CCP §580b to guarantors, some doubt on the issue will remain. However, any such provision can be waived by a guarantor. CC §2856.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.37 c. CCP §580d--Limitation on Deficiency After Trustee's Sale

§6.37 c. CCP §580d—Limitation on Deficiency After Trustee's Sale

Code of Civil Procedure §580d states that no deficiency judgment is available for any deficiency on a note secured by a deed of trust on real property when the lender has foreclosed under a power of sale (*i.e.,* through a nonjudicial foreclosure or trustee's sale). Although it has been held that CCP §580d does not directly prohibit the recovery of a deficiency judgment from a guarantor, guarantors have been afforded some indirect protection under the estoppel theory stated in *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64.

The court in *Gradsky* noted that a guarantor, on payment of the obligations, is subrogated to the lender's rights. See §6.27. The lender, by electing to proceed with a nonjudicial foreclosure, destroyed its right to obtain a deficiency against the borrower (and by virtue of the subrogation rules, also destroyed the guarantor's right to recovery of deficiency), so fairness dictated that the lender be estopped from recovering the deficiency from the guarantor.

NOTE: See discussion in §6.60 on enforceability of waivers of this defense and discussion of *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238. Following *Mariners*, explicit "*Gradsky* waivers" are now almost always incorporated in guaranty forms used by sophisticated lenders. See §6.79 for a form of *Gradsky* waiver.

The creditor's election of remedies in *Gradsky* resulted in the application of the estoppel doctrine barring the creditor from obtaining a deficiency judgment. *Union Bank v Gradsky* (1968) 265 CA2d 40, 47, 71 CR 64. The reliance on the estoppel doctrine in *Gradsky* lends credence to the observation that other applications of the estoppel doctrine may prevent a creditor from recovering a deficiency judgment against a guarantor:

- Delay or laches (*Tustin Community Hosp. v Santa Ana Community Hosp. Ass'n* (1979) 89 CA3d 889, 153 CR 76);
- Promissory estoppel (*Monarco v Lo Greco* (1950) 35 C2d 621, 623, 220 P2d 737);
- Equitable estoppel, also known as estoppel in pais (*Clegg v Sansing* (1961) 196 CA2d 575, 579, 16 CR 752; *Jones v Sunset Oil Co.* (1953) 118 CA2d 668, 673, 258 P2d 510); or
- Estoppel by silence (*R. D. Reeder Lathing Co. v Allen* (1967) 66 C2d 373, 378, 57 CR 841; *Bollinger v National Fire Ins. Co.* (1944) 25 C2d 399, 411, 154 P2d 399; *Elliano v Assurance Co. of Am.* (1970) 3 CA3d 446, 451, 83 CR 509).

In response to *Gradsky,* lenders regularly include a list of waivers of the right referred to in *Gradsky,* now commonly known as "*Gradsky* waivers."

Since *Gradsky,* no reported decision has invoked the estoppel doctrine to relieve a guarantor from liability. But the courts' scrutiny of lenders' activities in other areas concerning antideficiency protection suggests that the courts will carefully examine application of the estoppel doctrine in appropriate circumstances. Although it did not apply the "*Gradsky*/estoppel" theory to invalidate an indemnitor's liability following nonjudicial foreclosure, the court in *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 1312, 37 CR3d 83, concluded that the estoppel theory was a valid concept.

Whether estoppel exists is a question of fact. *Associated Creditors' Agency v Haley Land Co.* (1966) 239 CA2d 610, 617, 49 CR 1; *Goldstein v McNeil* (1954) 122 CA2d 608, 612, 265 P2d 113; *Krobitzsch v Middleton* (1946) 72 CA2d 804, 815, 165 P2d 729. Thus, numerous fact patterns might justify application of the estoppel doctrine. For instance, when a junior secured creditor is foreclosed out by a senior creditor and the junior creditor's delay in initiating or prosecuting an action against the debtor results in unfair prejudice to the guarantor, the guarantor may be able to claim the estoppel or laches doctrine as a defense. Although the courts have not addressed this precise issue, in *Tustin Community Hosp. v Santa Ana Community Hosp. Ass'n, supra* (which also involved tradename and injunction issues), the court set forth a detailed explanation of the laches and estoppel doctrines. The analysis in *Tustin* appears to be well reasoned and suggests that the trial courts analyze a claim based on estoppel or laches on a case-by-case basis.

The *Gradsky* estoppel rule does not apply to bar a lender from proceeding against the guarantor following a nonjudicial foreclosure on a purchase money note. *Bauman v Castle* (1971) 15 CA3d 990, 93 CR 565. The reason is

that CCP §580b would prevent the guarantor from recovering against the principal in any event in that context, so the lender's election to conduct a trustee's sale resulted in no additional prejudice to the guarantor.

For discussion of a guarantor's rights against the principal, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.38 5. True Guaranties and Purported or Sham Guaranties

§6.38 5. True Guaranties and Purported or Sham Guaranties

California courts have classified guaranties as falling into two types: "true" guaranties, *i.e.*, guaranties that represent obligations separate and distinct from liability on the underlying guaranteed obligation, and "purported" guaranties, *i.e.,* guaranties executed by one who is already personally obligated on the guaranteed obligation and is thus a de facto borrower. (The latter are often called "sham guaranties.") Antideficiency protections have been held applicable in situations involving purported guaranties, but they do not prohibit the recovery of deficiencies from guarantors who have executed true guaranties. *Union Bank v Brummell* (1969) 269 CA2d 836, 75 CR 234.

PRACTICE TIP: When faced with a purported guaranty issue, the lender must carefully consider the ramifications of the one-action rule of CCP §726 before bringing an action against the guarantor. See, *e.g.,* the cautionary tale told by the multiple decisions of *Prestige I-IV: Prestige Ltd. Partnership-Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership-Concord*) (Bankr ND Cal 1997) 205 BR 427, aff'd (9th Cir 1999) 164 F3d 1214 (*Prestige I*) (levy on assets of general partner/guarantor is action against partnership; thus lender waived its lien against real property security); *Prestige Ltd. Partnership-Concord v East Bay Car Wash Partners* (*In re Prestige Ltd. Partnership-Concord*) (Bankr ND Cal 1998) 223 BR 203 (*Prestige II*) (although lender lost its secured position under CCP §726, it retained unsecured debt enforceable in bankruptcy); *Prestige Ltd. Partnership-Concord v East Bay Car Wash Partners* (*In re Prestige Ltd. Partnership-Concord*) (9th Cir 1999) 164 F3d 1214 (*Prestige III*) (affirming *Prestige I*); *Prestige Ltd. Partnership-Concord v East Bay Car Wash Partners* (*In re Prestige Ltd. Partnership-Concord*) (9th Cir 2000) 234 F3d 1108 (*Prestige IV*) (affirming *Prestige II*). See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 4 (4th ed Cal CEB 2009).

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a. Partner Guarantors of Partnership Obligations

§6.39 (1) Traditional Analysis Before RUPA

Before enactment of the Uniform Partnership Act of 1994, generally known by the acronym "RUPA" (for "Revised Uniform Partnership Act") (Corp C §§16100-16962), the partnership was not viewed as an entity separate and distinct from the individual partners, and the guaranty added nothing to a partner's liability. *Union Bank v Dorn* (1967) 254 CA2d 157, 61 CR 893; *Riddle v Lushing* (1962) 203 CA2d 831, 21 CR 902.

The court in *Prestige III* (see §6.38) applied CCP §726 to void the lender's lien against the borrower/partnership's real property following the lender's attachment and levy on other assets of the guarantor, who was a general partner of a general partner of the borrower. In *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790, the court stated, in dictum, that had "the defendants themselves been the general partners of the borrowing partnership, and had they attempted to guarantee the partnership's debt, there is no question such guaranty would have been a sham." 38 CA4th at 1422. See also *Westinghouse Credit Corp. v Barton* (CD Cal 1992) 789 F Supp 1043. The court reiterated the established rule that a general partner who guarantees a loan to a partnership takes on no additional liability, because the partner is a principal obligor under the loan and is therefore protected by CCP §580d following a nonjudicial sale of real property collateral. The court also held that this result is *not* changed even if the debt is contractually nonrecourse to the borrower. Therefore, a nonrecourse provision in a promissory note does not prevent the application of §580d in favor of a general partner guarantor. Compare this result with that under CCP §580b, discussed in §6.36.

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§6.40 (2) Analysis Under RUPA

Beginning January 1, 1999, the Uniform Partnership Act, generally known by the acronym "RUPA" (for "Revised Uniform Partnership Act") (Corp C §§16100-16962), became applicable to every California partnership regardless of when it was formed. Under RUPA, the partnership is deemed to be a separate legal entity distinct from the general partners. Corp C §16201. In several important respects, the rights and remedies of a creditor against the partnership and against the partner are different from those under prior law.

RUPA expressly provides that all general partners of a partnership are liable jointly and severally for all partnership obligations; however, a person admitted to an existing partnership is not liable for a partnership obligation incurred *before* that person's admission as a partner. Corp C §16306.

Moreover, RUPA limits the authority of one partner to bind the partnership. Each partner in executing an instrument in the partnership's name binds the partnership if the act was for the apparent purpose of carrying on the partnership's ordinary business unless (1) the partner had no authority to act for the partnership in that matter and (2) the person dealing with the partner knew or had notice of the partner's lack of authority. Corp C §16301. If the act is not apparently for the purpose of carrying on the ordinary course of business, it must be authorized by the other partners.

To clarify the extent of authority of a partnership and its partners, the partnership may file a statement of authority with the Secretary of State under Corp C §16303 that supplements whatever actual or apparent authority a partner may otherwise have.

A statement that grants authority to transfer interests in the partnership's property is conclusive in favor of a person who gives value as long as

- that person had no knowledge to the contrary;
- the statement was recorded in the real property records; and
- the statement had not been canceled, and there was no other statement in the real property records that limited the authority.

A statement that limits the authority of a partner to transfer interests in the partnership's real property imparts knowledge to the general public if the statement is recorded in the real property records. Except for statements recorded in the real property records, filing a statement does not provide imputed knowledge to the public of a limitation on a partner's authority.

In addition, RUPA modifies a lender's right to recover against the general partner. To enforce a judgment against a general partner, the judgment must be entered against the partner as judgment debtor. The partner is not automatically liable on all judgments against the partnership. The judgment creditor cannot levy execution against the assets of the partner or partnership claim unless (Corp C §16307)

- a writ of execution against the partnership has been returned unsatisfied;
- the partnership is in bankruptcy;
- the partnership's assets are clearly insufficient to satisfy the partnership debt;
- liability is imposed on the partner by law or contract independent of the existence of the partnership; or
- the partner has agreed otherwise.

Thus, RUPA, while preserving the concept that a partner is liable for the partnership's debts, has altered the due diligence that a lender must perform. The partner's liability depends on the nature of the partnership's business, the scope of the partner's authority (actual, apparent, on file, or on record), the time when the partner became a partner, and the information made available to the lender. A lender must thoroughly review the records, files, and documents relating to the partnership.

If the lender ultimately determines that the general partner is obligated on the loan, a court will probably hold that the general partner is entitled to the protection of the one-action rule and the antideficiency laws. If the lender should decide that the partner is not obligated on the loan, the lender should have the partner sign either the note as co-

obligor or a guaranty. If the latter is signed, the guaranty is a true guaranty because the partner would not otherwise be obligated on the debt.

PRACTICE TIP: As a result of RUPA, a lender should have every general partner sign some form of document acknowledging personal liability and agreeing that, if a judgment is rendered on a partnership obligation, the creditor can pursue the general partner without pursuing the partnership. When new partners are admitted to the partnership, they too should sign a similar document.

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§6.41 (3) Intentionally Deleted

This section on argument for validity of partner's subsequent guaranty was deleted because of the supreme court's holding in *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292. See §6.51.

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§6.42 (4) Limited Partners

The discussion in §§6.39-6.40 relates only to general partners. A *limited* partner is not liable for the limited partnership's debts. Therefore, a limited partner may validly guarantee the limited partnership's debts.

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§6.43 (5) Limited Liability Partnerships

Another major change under the Uniform Partnership Act (Corp C §§16100-16962), generally known by the acronym "RUPA" (for "Revised Uniform Partnership Act"), is the creation of the limited liability partnership (LLP), which provides a partner greater protection from partnership liabilities but allows the partner to operate much as it would in an ordinary partnership.

Under Corp C §16306, a partner in a registered limited liability partnership is not liable, directly or indirectly, for a partnership's debts by reason of being a partner. However, a partner in such a partnership may be liable for all or specified partnership debts if the partners holding the majority of the partnership interests in current profits (or such other percentage as may be required in the partnership agreement) specifically agree before the debt is incurred to be liable. Such authorization, however, may be terminated at any time for future obligations.

Section 16303 expressly states that it is not intended to affect or impair the partner's ability to act as a guarantor.

Any lender dealing with an LLP must either be certain that the agreement is binding on the partners or obtain each partner's signature on the underlying note (in which event the partner is a "coborrower") or on a guaranty. Such a guaranty is a "true" guaranty.

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§6.44 b. Corporate Shareholder Guarantors of Corporate Obligations

In general, a corporate shareholder is not personally liable for the debts of the borrower corporation. In certain circumstances, however, guaranties executed by corporate shareholders are not true guaranties. This result is based on the alter ego theory, under which the shareholders themselves claim that the corporation is a mere instrumentality and that the corporate obligations are actually those of the individual shareholders. See *Valinda Builders, Inc. v Bissner* (1964) 230 CA2d 106, 40 CR 735. The mere fact that guarantors are also sole shareholders and principal officers and directors of the corporation whose note has been guaranteed does not, by itself, constitute grounds for applying antideficiency protections to such guarantors. Some showing must be made that "adherence to the fiction of separate existence would… promote fraud or injustice." *Heckes v Sapp* (1964) 229 CA2d 549, 554, 40 CR 485. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009) for discussion of guarantors as alter egos.

The potential importance of the sham guaranty defense was demonstrated in *River Bank Am. v Diller* (1995) 38 CA4th 1400, 45 CR2d 790. In affirming the trial court's refusal to grant summary judgment for the lender on the issue of the sham guaranty, the court held that there was a "triable issue of fact whether, by structuring the loan transaction as it did, the lender subverted the purpose of the antideficiency laws 'by making a related entity the debtor while relegating the principal obligors to the position of guarantors.'" 38 CA4th at 1423. In holding for the guarantors, the *River Bank* court noted that the lender and the borrower had originally intended to form a joint venture for the purchase and development of the subject property; that the lender belatedly "restructured" the deal as a participating secured loan; that the general partner of the borrower was a "shell" corporation owned by the guarantors but without significant assets; and that the lender had taken an active role in designating the composition of the partnership/borrower but had never verified its financial condition or that of its corporate general partner.

The Ninth Circuit Court of Appeals rejected an alter ego defense by a corporate guarantor of the purchase money obligations of its individual shareholders in *Paradise Land & Cattle Co. v McWilliams Enters.* (9th Cir 1992) 959 F2d 1463. The court held that the guaranty is not a purchase money obligation and is not, therefore, subject to the antideficiency rules. The Ninth Circuit emphasized two facts that it said distinguished its holdings from earlier California cases that had extended antideficiency protection to shareholder/guarantors: First, the guarantor in *Paradise Land & Cattle* was a corporation rather than an individual, and extension of antideficiency protection (here, CCP §580b) was deemed not as urgent when "the guarantor is a corporation whose owners are protected by the central feature of corporations: limited liability." 959 F2d at 1467. Second, the court was impressed that the corporation had a long history and substantial assets, as opposed to the dummy corporations set up in the cases that had found the guaranties to be shams.

WARNING: Taken together, the *Paradise Land & Cattle* and *River Bank* cases are a warning shot aimed at lenders who have relied on guaranties to finesse California's one-action and antideficiency rules. Lenders' counsel (and borrowers' counsel giving enforceability opinions) should be particularly wary when the guarantors are individuals who are shareholders or officers of the borrower or its general partner, when early correspondence between the parties suggests that the loan is to be made to the persons eventually designated as guarantors, when the borrower (or its corporate general partner) is newly formed or a single-asset entity, or when the lender has given input on the formation of the borrower company.

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§6.44A c. Guarantors of Nonrecourse Loans

It has been argued that the guarantor of a nonrecourse loan is essentially the prime obligor and is thus entitled to the protection of California's antideficiency legislation, for which waivers are generally void as against public policy. A true guarantor of a nonrecourse loan is liable for a deficiency assuming an appropriate waiver of the one form of action and antideficiency language. See CC §2856. See also §§6.51-6.59. When the guarantor is essentially the primary obligor of a nonrecourse loan, the courts have held that such an arrangement circumvents the purpose of the one form of action rule and antideficiency legislation. See *Westinghouse Credit Corp. v Barton* (CD Cal 1992) 789 F Supp 1043, 1045. As a consequence, such guaranties have been treated as part of the primary obligation and entitled to the protections available to the primary obligor. See *Westinghouse Credit Corp v Barton*, *supra*. See also California Mortgages, Deeds of Trust, and Foreclosure Litigation §§9.95-9.105 (4th ed Cal CEB 2009); Freeman & Gurev, *An Overview of Defenses Available to Guarantors of Real Property Secured Transactions Under California Law,* 38 Santa Clara L Rev 329, 346 (1998). The provisions of CC §2856 validating a true guarantor's waivers do not appear to change the line of cases establishing this principle. The impact of the borrower's identity theory (*i.e.,* treating the borrower and the third party as merged) was held inapplicable to an indemnitor as opposed to a guarantor in *Trust One Mortgage Corp. v Invest Am. Mortgage Corp.* (2005) 134 CA4th 1302, 37 CR3d 83. The court went to great lengths to distinguish indemnitors and guarantors and the different relationship of each to the borrower's obligation.

PRACTICE TIP: In order to avoid a situation in which the guarantor and primary obligor are considered to be merged, a lender should obtain representations and warranties to establish the separate nature of the guarantor and primary obligor. The lender may also wish to obtain a legal opinion verifying the distinctiveness of the two parties. See Mortgage Deed of Trust Foreclosure §§9.107-9.109.

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§6.45 6. Impact of Bankruptcy on Guaranty

In evaluating the enforceability of a guaranty, a party must consider the possible impact of a bankruptcy filed by the primary obligor on the liability of the guarantor. The customary terms of a guaranty will often include an explicit statement that the guarantor will remain liable notwithstanding the filing of a bankruptcy petition by the primary obligor. See §6.81; see also *Star Phoenix Mining Co. v West Bank One* (9th Cir 1998) 147 F3d 1145; *Underhill v Royal* (9th Cir 1985) 769 F2d 1426 (confirmation of plan of reorganization preventing collection from guarantor held unenforceable). For form, see §6.81. Despite such language, however, there are certain situations in which the liability of a guarantor may be discharged or limited. See §§6.45A-6.45B.

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§6.45A a. Discharge Under Chapter 11 Plan of Reorganization

Bankruptcy courts have been inconsistent in the treatment of discharges of third parties, such as guarantors, under Chapter 11 Plans of Reorganization. Some courts have held that a discharge of third parties is inappropriate and could be grounds for denying confirmation of the plan. See *In re E-H Farms* (Bankr ND Tex 1999) 238 BR 661. Other courts have held that if a plan of reorganization containing a third party release is confirmed, it will have some binding effect. See *In re Keck, Mahin & Cate* (Bankr ND Ill 1999) 241 BR 583 (under 11 USC §1123(b), Chapter 11 plan could release some partners of debtor from liability to landlord in exchange for contributions to debtor's estate).

As part of a plan of reorganization under Chapter 11, the plan can release third parties from liability when (*In re Zenith Electronics Corp*. (Bankr D Del 1999) 241 BR 92)

- there is an identity of interest between the debtor and the third party;
- the third party has made a substantial contribution to the assets of the reorganization;
- without the release there is little likelihood of success of reorganization;
- there is substantial agreement by a majority of the creditors; and
- the plan provides for substantial payment to the creditors.

Moreover, the release will apply only to consenting creditors who approved the Chapter 11 plan. *In re Dow Corning Corp.* (Bankr ED Mich 1999) 244 BR 721.

In *Great Lakes Higher Educ. Corp. v Pardee (In re Pardee)* (9th Cir 1999) 193 F3d 1083, the court held that a creditor that failed to object to the bankruptcy plan or to appeal the plan confirmation order waived the right to collaterally attack the confirmed plan after confirmation. See also *Stratosphere Litig. L.L.C. v Grand Casinos, Inc.* (9th Cir 2002) 298 F3d 1137 (creditor who fails to object to legality of confirmation plan or appeal order of confirmation is barred by res judicata from collaterally attacking plan even if plan illegally released third party nondebtor); *Ground Sys., Inc. v Albert* (*In re Ground Sys., Inc.)* (BAP 9th Cir 1997) 213 BR 1016 (plan terms containing guarantor's release are res judicata if confirmation order is not appealed).

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§6.45B b. Rent Cap Under 11 USC §502(b)(6)

The liability of a guarantor may be limited under 11 USC §502(b)(6), which caps the claim of the landlord for prospective rent on a lease of nonresidential real property to the greater of one year or 15 percent of the remaining term of the lease not to exceed three years. Ordinarily, a landlord will be entitled to such amount *plus* the prepetition unpaid rent (without acceleration) or presurrender rent. 11 USC §502(b)(6)(B). The rent cap does not apply to the amount owing on the date of bankruptcy. See *Vause v Capital Poly Bag, Inc. (In re Vause)* (6th Cir 1989) 886 F2d 794. If the landlord successfully mitigates its damages to an amount less than the cap, the landlord's claim will not exceed the actual damages. *In re Iron-Oak Supply Corp.* (Bankr ED Cal 1994) 169 BR 414.

Courts have held that the rent cap limitation applies even when a solvent tenant files a bankruptcy petition for the purpose of limiting the landlord's damage claim. See *In re PPI Enters., Inc.* (Bankr D Del 1998) 228 BR 339, aff'd (3d Cir 2003) 327 F3d 197 (not bad faith for debtors to file bankruptcy to take advantage of rent cap limitation); *In re Federated Dep't Stores, Inc.* (SD Ohio 1991) 131 BR 808; *In re W. & L. Assocs., Inc.* (Bankr ED Pa 1987) 71 BR 962.

The rent cap limits the landlord's rights to the collateral; proceeds of the collateral must be applied to reduce the amount of rent as capped, and any excess collateral must be released unless it is collateral for another obligation. See *In re All for a Dollar* (Bankr D Mass 1996) 191 BR 262; *In re Conston Corp.* (Bankr ED Pa 1991) 130 BR 449; *Oldden v Tonto Realty Co.* (2d Cir 1944) 143 F2d 916.

Similarly, courts have held that the rent cap limits the landlord's rights to the proceeds of a letter of credit that supports the lease; thus, proceeds of a letter of credit must be applied to reduce the capped rent claim. *AMB Prop., L.P. v Official Creditors for Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)* (9th Cir 2005) 416 F3d 961; *In re PPI Enters., Inc., supra; Redback Networks, Inc. v Mayan Networks Corp.* (*In re Mayan Networks Corp.)* (BAP 9th Cir 2004) 306 BR 295. See Shelby & McFadden, *Reader Alert: In re Mayan Networks Corporation—Letter of Credit Draw Effect on an Allowed Claim Under 11 USC §502(b)(6)*, 22 Cal Real Prop J 15 (2004). In a case in which the landlord did not file a proof of claim for lease rejection damages in the tenant's bankruptcy, however, one court has held that the landlord was entitled to the full letter of credit given as security and that the rent cap under Section 502(b)(6) did not apply. *EOP-Colonnade of Dallas v Faulkner (In re Stonebridge Technologies, Inc.)* (5th Cir 2005) 430 F3d 260, 271.

When the bankrupt party is the guarantor, the rent cap has been applied to limit liability on the guaranty of a lease. *Arden v Motel Partners (In re Arden)* (9th Cir 1999) 176 F3d 1226. But when a nonbankrupt party guarantees the obligations of a bankrupt lessee, the liability of the cotenant or guarantor is not altered by the rent cap. *Kopolow v P.M. Holding Corp. (In re Modern Textile, Inc.)* (8th Cir 1990) 900 F2d 1184. However, the ruling in *Redback Networks, Inc. v Mayan Networks Corp., supra* could be interpreted as limiting recourse against a guarantor.

A guarantor's independent right of reimbursement from its principal under CC §2847 (which is distinct from the right of subrogation under CC §2848) and the guarantor's right to the benefit of any collateral under CC §2849 could support limitation on recovery under the guaranty.

PRACTICE TIP: The party relying on the guaranty should review the guaranty's waiver language to make certain that the guarantor has explicitly waived any defenses that it has under 11 USC §506(b).

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§6.45C c. Springing and Exploding Guaranties

Some lenders have attempted to avoid the primary obligor's utilization of bankruptcy in the event of foreclosure by having insiders (shareholders, directors, or officers) execute guaranties that "spring" into effect if bankruptcy is utilized or "explode" if bankruptcy is not entered into voluntarily. See *In re Pease* (Bankr Neb 1996) 195 BR 431, 433 (waiver of automatic stay unenforceable as against public policy); *In re Weitzen* (SD NY 1933) 3 F Supp 698 (agreement to waive bankruptcy protection unenforceable); 11 USC §365(e) (ipso facto clause prohibits provisions for additional rights and remedies to creditor in event of bankruptcy). Thus, to the extent that springing or exploding guaranties circumvent the bankruptcy laws or confer additional rights in a bankruptcy to a creditor, such guaranties should fail. See generally Leon*, Exploding and Springing Insider Guarantees of Real Estate Loans: As a Bankruptcy Protection Device, They May Prove To Be Duds*, 18 Prob & Prop 57 (Jan.-Feb. 2004).

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§6.46 C. Waivers

As is evident from §§6.26-6.45, an intricate network of defenses and rights is available to protect a guarantor, which limits a lender's ability to collect on its guaranty. In general, California courts have held that, unlike the protections available to a principal debtor, a "true" guarantor may generally waive statutory protections. However, see §6.6 concerning certain limitations on the enforceability of waivers under Commercial Code Division 9, which apply to protect the guarantor (as well as the primary obligor) when the underlying obligation guarantied is secured by personal property (with or without real property collateral).

Most litigation between a lender and a guarantor focuses on whether the guarantor's rights and defenses were subject to waiver and, if so, whether the waiver is effective. Generally, the courts construe guarantor waivers strictly against the creditor. *Pearl v General Motors Acceptance Corp.* (1993) 13 CA4th 1023, 16 CR2d 805. Moreover, courts are authorized under CC §1670.5 to refuse enforcement of an unconscionable provision.

Much doubt about the validity of waivers of suretyship defenses and rights has been eliminated, however, by CC §2856, which broadly authorizes waivers of *all* statutory and common law rights granted to sureties. See §§6.55-6.59.

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§6.47 1. Waiver of Diligence and Demand

The courts have upheld the waiver of diligence and demand of payment (CC §2807), which establishes that a guarantor is liable under the guaranty immediately on the borrower's default without demand on, or notice to, the guarantor. See *Baralat Dev. Co. v Lichter* (1987) 191 CA3d 933, 236 CR 701 (creditor's failure to notify guarantor of principal's default did not affect guarantor's liability).

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§6.48 2. Waiver of Notice and Disclosure

The California Supreme Court, in *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564, held that a creditor who accepts a continuing guaranty owes a duty to the guarantor to disclose facts to the guarantor if the creditor has reason to believe that such facts materially increase the risk beyond that which the guarantor intended to assume. The court recognized, however, that the disclosure duty owed by the creditor to the guarantor depends on the nature of the guaranty agreement. A carefully drafted waiver provision could minimize the lender's duty of disclosure.

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§6.49 3. Exhaustion of Security; Proceeding Against Borrower; Exercise of Rights and Remedies Under Loan Documents

Courts have recognized that a guarantor may waive the right to require the creditor to proceed against the borrower or to pursue any other remedy that would lighten the guarantor's burden (CC §2845) or to proceed against any collateral provided by borrower (CC §2850) when the guaranty obligation is made or renewed. As a result, almost all guaranty forms explicitly waive these protections. See *Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238.

Likewise, the guarantor's right to the benefit of every security held by the lender for the performance of the principal obligation, whether the guarantor was aware of the security or not (CC §2849), may also be waived by the guarantor. *Brunswick Corp. v Hays* (1971) 16 CA3d 134, 93 CR 635.

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§6.50 4. Modifying the Obligation

Modifying the obligation without the guarantor's consent makes the guaranty unenforceable. CC §2819; see §6.30. A provision waiving the benefits of §2819, stating that the guaranty remains enforceable even if the lender modifies the obligation without the guarantor's consent, was upheld in *Stevenson v Oceanic Bank* (1990) 223 CA3d 306, 272 CR 757. In *Stevenson,* a corporate officer who personally executed a loan guaranty for a line of credit extended to the corporation sued the bank, alleging that the bank's failure to enforce a loan condition constituted breach of contract and negligent misrepresentation. The court held that the bank had not breached the guaranty agreement in waiving certain conditions of the underlying loan, because the bank was authorized to do so by the guaranty agreement, which provided that it could change the terms of indebtedness.

PRACTICE TIP: Despite *Stevenson,* a lender should, as a practical matter, seek to obtain the guarantor's written consent before modifying or waiving any material obligation in the financing. By failing to do so, a lender risks a court's discharging a guarantor whose interest is injured by the modification or waiver, despite specific waiver language in the guaranty. If a lender adopts such a policy, however, it needs to follow its procedure in each case or risk a claim that the lender breached an implied covenant.

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§6.51 5. One-Action and Antideficiency Waivers

California courts have regularly held that the one-action rule of CCP §726 and the antideficiency laws of CCP §§580a, 580b, and 580d state a fundamental public policy and that the protections of these statutes cannot be waived by a borrower or trustor in advance of a default under the loan document. See also CC §2953. In fact, the California Supreme Court's decision in *DeBerard Props., Ltd. v Lim* (1999) 20 C4th 659, 85 CR2d 292, held that the protections of CCP §580b could not be waived by a borrower at any time, whether before or after a default. Although *DeBerard* primarily rests on the precise language of CCP §580b—which differs markedly from the other statutory one-action and antideficiency statutes—at least one part of the supreme court's rationale could be applied to CCP §§580a, 580d, and 726 and interpreted as meaning that the protection of these statutes, likewise, could not be waived at all. Whether the supreme court meant to overrule its prior decisions upholding postclosing waivers of CCP §§580d and 726 (*e.g., Salter v Ulrich* (1943) 22 C2d 263, 138 P2d 7) remains unclear.

Despite these waiver limitations in favor of borrowers, California courts have in general allowed guarantors to waive protections under the one-action rule and under the antideficiency laws. Because these statutes are supported by strong public policy, courts required that the waivers be extremely precise and contain extensive disclosures. In response, the legislature enacted CC §2856 to provide guidance on guarantors' waivers. The first version of §2856 enacted in 1994 proved ineffective because of its wording deficiencies; the current version was enacted in 1996.

For further discussion of one-action and antideficiency waivers, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5, 9 (4th ed Cal CEB 2009).

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a. Background of CC §2856

§6.52 (1) *Bank of S. Cal. v Dombrow*

Although *Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 46 CR2d 656) has been depublished and is not citable, it has not been overruled. *Dombrow* held the following:

- A guarantor has CCP §580a protection, and therefore a creditor's recovery against a guarantor following a trustee's sale is limited to the difference between the (preforeclosure) unpaid debt and the fair market value of the property sold (see §6.35 for discussion of §580a); and
- The subject guarantor did not waive CCP §580a protection, and it is unclear whether public policy permits such a waiver.

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§6.53 (2) Legislative Response

The legislature enacted CC §2856 in 1994 and then enacted a second version in 1996 to clarify guarantor waiver uncertainties created by judicial decisions. The 1994 version of the statute (former CC §2856), sought to dispel *Gradsky* waiver (*Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64) uncertainties created by *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, discussed in §6.58. The 1996 version (CC §2856) (Stats 1996, ch 1013), effective January 1, 1997, was enacted in response to *Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 46 CR2d 656). See §6.52. The 1996 version of CC §2856 clearly authorizes a guarantor to waive any antideficiency and one-action protections the guarantor may have, thus settling *Dombrow*'s doubts about the validity of such waivers. Although the 1996 version of §2856 contains additional authorizations for guarantor antideficiency waivers, it also continues the (*Gradsky* waiver) substance of the 1994 statute.

NOTE: The language of the "model waivers" is now narrower than the scope of rights authorized to be waived by the statute. The inconsistency between the "model waivers" and the statutory language arose from the reluctance of certain institutional lenders to support the 1996 statutory revisions if it required them to revise their printed guaranty forms.

In view of the extensive nature of past litigation in this area of the law and the apparent willingness of California courts to find exceptions or qualifications exonerating guarantors, a lender should hope but not assume that the present form of CC §2856 necessarily resolves this area of the law.

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§6.54 (3) Former CC §2856

The principal difference between the two versions of CC §2856 is that the former statute's substantive provisions on antideficiency waivers (former CC §2856(a)(2)) were less broadly worded than those of the current statute (at CC §2856(a)(3)). See §6.57, discussing CC §2856(a)(3). The former statute included a model waiver that clearly waived the *Gradsky* defense, but it did not clearly waive other antideficiency protections. The consumer loan exception of the former statute (at former CC §2856(c)) was not limited to purchase money loans (as in the current CC §2856(e), discussed in §6.58).

Proposed language of intent (in an earlier version of AB 3101, later enacted as Stats 1994, ch 1204) to abrogate *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, was replaced by a statement that former CC §2856(a)-(b) was declarative of, and did not represent a change in, existing law. Stats 1994, ch 1204, §2. Although *Cathay Bank* has not technically been abrogated, to the extent former CC §2856(a)-(b) is inconsistent with *Cathay Bank,* it retroactively supersedes it. The two subsections are inconsistent with *Cathay Bank* in that they allow a more succinct description, and require less explanation, of the *Gradsky* defense and its possible consequences.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.55 b. Civil Code §2856

§6.55 b. Civil Code §2856

The substantive provisions of CC §2856 authorize a true guarantor to waive three types of protections. In addition, to facilitate drafting an enforceable waiver, the statute contains model forms of the various waivers. The three types of protections that may be waived are rights or defenses based on the following:

- Subrogation, reimbursement, indemnification, and contribution;
- A creditor's election of remedies; and
- CCP §580a, §580b, §580d, or §726 (see §6.57).

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§6.56 (1) Retroactivity

The current version of CC §2856, which became effective in 1997, added CC §2856(f), making the waiver provisions of CC §2856 prospective only. The validity of a waiver executed before January 1, 1997, must be determined by the law in existence on the date the waiver was executed.

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§6.57 (2) Antideficiency Waivers

The third waiver authorization, at CC §2856(a)(3), allows a true guarantor to waive defenses based on CCP §§580a, 580b, 580d, and 726. This provision is more broadly worded than its predecessor, former CC §2856(a)(2), which allowed a guarantor to waive antideficiency defenses the guarantor "may have by reason of protection afforded to the *principal*" (emphasis added) on the guaranteed obligation. The former provision left open the question of waivers of direct guarantor antideficiency protections, such as the CCP §580a protection that *Bank of S. Cal. v Dombrow* (ordered not published Mar. 14, 1996; former opinion at 39 CA4th 1457, 46 CR2d 656) later held to exist. See §6.52 on *Dombrow.* The former language resulted from the legislature's 1994 focus on *Gradsky* waivers (see §6.37) and on uncertainties created by *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420. Under the current CC §2856(a)(3), a guarantor may waive

> [a]ny rights or defenses the guarantor or other surety may have because the principal's note or other obligation is secured by real property or an estate for years. These rights or defenses include, but are not limited to, any rights or defenses that are based upon, *directly or indirectly*, the application of Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure *to the principal's note or other obligation*. [Emphasis added.]

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§6.58 (3) Model Waivers

The statute contains two model (or safe harbor) waivers, the first of which, at CC §2856(c), waives (as permitted by CC §2856(a)(2)-(3)) election of remedies and antideficiency protections. The CC §2856(c) model waiver provides that

> [t]he guarantor waives all rights and defenses that the guarantor may have because the debtor's debt is secured by real property. This means, among other things:
> (1) The creditor may collect from the guarantor without first foreclosing on any real or personal property collateral pledged by the debtor.
> (2) If the creditor forecloses on any real property collateral pledged by the debtor:
> (A) The amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price.
> (B) The creditor may collect from the guarantor even if the creditor, by foreclosing on the real property collateral, has destroyed any right the guarantor may have to collect from the debtor.
> This is an unconditional and irrevocable waiver of any rights and defenses the guarantor may have because the debtor's debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based upon Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure.

Although the above model (at (2)(B)) waives a guarantor's defense based on election of remedies, the current statute also has a separate election of remedies model waiver, appearing at CC §2856(d):

> The guarantor waives all rights and defenses arising out of an election of remedies by the creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guaranteed obligation, has destroyed the guarantor's rights of subrogation and reimbursement against the principal by the operation of Section 580d of the Code of Civil Procedure or otherwise.

The addition of the first word of the above waiver, "The," is the only change from the model *Gradsky* waiver appearing at former CC §2856(b).

PRACTICE TIP: Lenders should consider including the model waivers or similar language in their guaranties.

WARNING: The model waivers of CC §2856(b) were not intended to apply to loans secured by a one-to-four-unit family dwelling occupied by the borrower if the loan was used to pay all or part of the purchase price for the dwelling (so-called consumer purchase money loans). CC §2856(e). As a result, in connection with such loans, the lender should be careful to provide in the waiver language of the level of specificity required by *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, and should include additional language elaborating on the decision in *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64, *i.e.,* that the destruction of the guarantor's subrogation rights creates a defense to a deficiency judgment on the guaranty, and making clear that the guarantor understands that he or she is waiving any such defense to the guaranty.

In *Cathay Bank,* the court addressed the specificity required for an enforceable *Gradsky* waiver, holding that the waiver in the guaranty in question was not sufficiently explicit. See §6.37 for discussion of *Gradsky* waivers. The court indicated that the waiver must expressly state that (a) the destruction of subrogation rights creates a defense to a deficiency judgment and (b) the guarantor is now waiving that specific defense.

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§6.59 (4) Requisite Waiver Language

Civil Code §2856(b) makes it clear that, despite the model waiver language, no particular waiver language is required.

NOTE: This statute should effectively undermine the tortured rationale of *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, which refused to enforce a "plain English" *Gradsky*-waiver (see §6.58) on the purported basis that the waiver must expressly state that the destruction of subrogation rights creates a defense to a deficiency judgment and the guarantor is now waiving that specific defense. But see Freeman & Gurev, *An Overview of Defenses Available to Guarantors of Real Property Secured Transactions Under California Law*, 38 Santa Clara L Rev 329, 340 (1998), suggesting that the legislature did not intend to override *Cathay Bank,* and that its rationale continues to apply outside §2856(b)'s safe harbor.

An overly broad waiver of "all suretyship defenses and defenses in the nature thereof" may still be insufficient. *Indusco Mgmt. Corp. v Robertson* (1974) 40 CA3d 456, 461, 114 CR 47. See, *e.g.,* description of suretyship rights and defenses waived in §§6.26-6.60. Additionally, in *WRI Opportunity Loans II, LLC v Cooper* (2007) 154 CA4th 525, 545, 65 CR3d 205, the court concludes that CC §2856(a) is not intended to abrogate or modify usury rules used against the enforcement of unlawful transactions.

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§6.60 6. Other Waivers/Releases

Most sophisticated lenders require guarantors to waive the protection under CCP §580d. Whether such a waiver is effective has not yet been tested in California courts, but, on the basis of analogy to the *Gradsky* waiver (*Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64; see §6.37), such a waiver should be enforceable.

Further, *Gradsky, Mariners Sav. & Loan Ass'n v Neil* (1971) 22 CA3d 232, 99 CR 238, and *In re Pon* (Bankr ND Cal 1994) 164 BR 322 held that the *Gradsky* defense can also be waived by conduct. In *Mariners* and *Pon,* the lender had tendered the note and deed of trust to the guarantor before the nonjudicial foreclosure. It is unclear whether an enforceable waiver based on conduct will be subject to, and survive, the type of analysis applied in *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, and *Resolution Trust Corp. v Titan Fin. Corp.* (9th Cir 1994) 22 F3d 923, although the Bankruptcy Court in *Pon* indicated that a waiver by conduct resulting from failure to accept a tender of the note would be enforceable if it represented the intentional relinquishment of a known right. Such waivers are not covered by CC §2856.

PRACTICE TIP: If a lender desires to pursue existing guaranties with potentially ineffective *Gradsky* waivers, it should at least tender the note and the deed of trust to the guarantor as in *Mariners* and *Pon.*

Lenders should be aware of situations that have the potential of releasing the guarantor from liability. For example, the guarantor may be released if the lender makes a full credit bid at the foreclosure sale for the balance due on the loan. See *Cornelison v Kornbluth* (1975) 15 C3d 590, 125 CR 557. In *Cornelison,* the mortgagee bid the full amount of the obligation owing at the foreclosure sale. The court held that the mortgagee could not recover damages for waste, because he could not establish any impairment of security. If the full amount owing to the lender is bid, the lien on the property is extinguished.

Even though *Cornelison* dealt with waste, the rationale for limiting the deficiency judgment should apply in the guaranty context. The purpose of the foreclosure sale is to determine the value of the property. If the full price is bid, then no impairment of security can be proved. But see *Guild Mortgage Co. v Heller* (1987) 193 CA3d 1505, 239 CR 59 (suit for fraud against borrower allowed even though lender made full credit bid at trustee's sale).

It is unlikely that the lender can avoid problems arising from a full credit bid, even with careful drafting of the guaranty.

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§6.61 D. Subordination of Guarantor's Rights

Lenders frequently demand that their rights against the borrower be superior to any rights that the guarantor has against the borrower. The standard limitation on and subordination of the guarantor's rights remain in effect as long as the borrower's obligations to the lender remain unsatisfied. The rights that the guarantor usually subordinates are the guarantor's right of reimbursement and indemnity and the right of subrogation that the guarantor would have on making partial payment of the guaranteed obligation. Subordination is distinguished from the outright waiver of rights discussed in §6.64.

The rationale for such subordination is that the lender does not want to have the guarantor competing with the lender for the borrower's assets, whether in a borrower liquidation or otherwise, until the lender is paid in full. Despite these concerns, a guarantor cannot be subrogated to a creditor's rights against the primary obligor until the guarantor fully satisfies the debt. CC §2848. See *American Contractors Indem. Co. v Saladino* (2004) 115 CA4th 1262, 9 CR3d 835 (analyzing full satisfaction of debt in analogous surety bond case). There is no such thing as partial subrogation. When the guarantor is the borrower's employee or has a legitimate contractual business relationship with the borrower, exceptions are usually made to allow receipt of current (*i.e.,* not past due) salary and/or current payments made in the ordinary course of business for goods provided or services rendered. For form, see §6.80.

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1. Impact of Bankruptcy

§6.62 a. *Deprizio* Waivers

Until the enactment of the Bankruptcy Reform Act of 1994 (Pub L 103-394, 108 Stat 4106), there was a question whether the execution of a guaranty by an "insider" of the principal debtor would expose the lender to additional liability in a bankruptcy of the principal debtor. This question arose because of the court's holding in *Levit v Ingersoll Rand Fin. Corp.* (7th Cir 1989) 874 F2d 1186, commonly called *Deprizio* because of the bankrupt's name. The court held that a borrower's payments to a lender who held a guaranty were recoverable as preferential payments if made within one year before the borrower's bankruptcy, rather than the 90-day preference period applicable to noninsiders. This was so even though the lender would have been immune from that attack without the guaranty. As a result, lenders were advised to obtain an outright waiver of all the guarantor's rights of reimbursement and indemnity and any rights of subrogation against the borrower.

These *Deprizio* waivers were aimed at eliminating the characterization of the insider guarantor as a creditor of the debtor because, if these rights were waived, theoretically the insider guarantor could not be a creditor of the debtor based on such rights. If the payments made by the debtor to the noninsider creditor were not "for the benefit of a creditor" (*i.e.,* the insider guarantor), then one of the essential elements for a preference had not been satisfied. Applying local law, several bankruptcy courts have upheld *Deprizio* waivers. See, *e.g., In re Fastrans, Inc.* (Bankr ED Tenn 1992) 142 BR 241; *Hostmann v First Interstate Bank (In re XTI Xonix Technols.)* (Bankr D Or 1993) 156 BR 821. Still another court had suggested that such waivers of a guarantor's subrogation rights arising in connection with the guaranty might not be sufficient to solve the *Deprizio* problem if the borrower has other liabilities to the guarantor independent of the guaranty, and that such claims must also be waived. *Tidwell v AmSouth Bank (In re Cavalier Homes)* (Bankr MD Ga 1989) 102 BR 878, 886 n18.

NOTE: *Deprizio* has been followed in the Ninth Circuit. See *In re Sufolla, Inc.* (9th Cir 1993) 2 F3d 977.

The enactment of 11 USC §550(c) by the Bankruptcy Reform Act of 1994 §202 (Pub L 103-394, 108 Stat 4106) overruled this holding of *Deprizio*. As amended, 11 USC §550 provides that the bankruptcy trustee may not recover payments from a transferee that is not an insider outside the 90-day period. As a result of this federal statutory overruling of *Deprizio,* lenders need no longer require, as many had been doing, that the insider guarantor waive its subrogation, reimbursement, and indemnity rights against the debtor.

The retroactive application of the Bankruptcy Reform Act of 1994 was upheld in *Official Comm. of Unsecured Creditors v Bank of America (In re ABC-NACO, Inc.)* (Bankr ND Ill 2005) 331 BR 773.

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§6.63 b. Disadvantages of *Deprizio* Waivers

Some guaranties in common use still contain *Deprizio* (see *Levit v Ingersoll Rand Fin. Corp.* (7th Cir 1989) 874 F2d 1186) waivers even though they are no longer necessary. See §6.62. This is *not* a recommended practice, because they could possibly undermine the lender's position. If the guarantor does not have rights of subrogation or reimbursement, it would be imperative for the guarantor to avoid making any payments on the guaranty; otherwise, the guarantor would receive little or no consideration for such payment, *i.e.,* the guarantor could not collect from the borrower the amounts that it paid to the lender. This fact would then raise several problems. First, by depriving a guarantor of its potential recovery through reimbursement or subrogation, the chances of rendering the guarantor insolvent under the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439.01-3439.12) may be substantially increased. See §6.15. Second, if the guarantor was in a position to control the actions of the borrower, the lender might arguably be "in control" of the borrower based on the guarantor's extreme motivation to have the borrower pay the lender's claim at all costs.

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§6.64 c. Distinguishing Subordination From Waiver [Deleted]

Discussion in this section of *O'Neil v Orix Credit Alliance, Inc.* (*In re Northeastern Contracting Co.*) (Bankr D Conn 1995) 187 BR 420 has been deleted because this case was vacated and remanded by *O'Neil v Orix Credit Alliance, Inc. (In re Northeastern Contracting Co.)* (Bankr D Conn 1998) 233 BR 15.

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§6.65 2. Special Qualifications for Corporate Obligations

Lenders often require guaranties from parent corporations (guaranteeing the obligations of subsidiaries) and from a corporation's principal shareholders and officers. The borrowers often owe these same parent companies and principal shareholders other monetary undertakings or obligations, or salary obligations to the shareholder/officers. The borrower and guarantors, therefore, often negotiate modifications of the subordination to allow a guarantor to receive loan repayments or salary or dividend payments. See discussion in §6.44 on alter egos and corporate guaranties by parents or subsidiaries. See §6.80 for form provision.

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§6.66 E. Reinstatement of Guaranty After Refund of Payment

Occasionally, lenders are faced with a situation in which a guaranteed obligation is paid in full and the borrower later files for bankruptcy and voids the payment on various bankruptcy grounds. If the lender refunds the voided payment to the borrower, the guarantor may be able to argue that the payment of the obligation by the borrower terminated the guaranty, which did not automatically revive on refund. Although arguments could be made to the contrary, a lender may want to avoid all such arguments. As a result, guaranties often provide that the guaranty will revive after payment of the debt if the lender is forced to return money to the debtor, *i.e.,* if a bankruptcy trustee requires the lender to disgorge payments. For form, see §6.87.

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III. GUARANTY AGREEMENT

§6.67 A. Elements of Enforceable Guaranty

Few elements are absolutely necessary for an enforceable guaranty. The provisions in §§6.68-6.73 are sufficient to create a binding guaranty. For further discussion of the basic elements of a guaranty, see §§6.12-6.25.

Owing to the difficulty many lenders encounter in attempting to enforce a guaranty, there are many other provisions that a careful lender may want to include in its guaranties when appropriate. See, *e.g.,* the additional guaranty provisions in §§6.74-6.106.

There is *no* standard form guaranty that applies to every type of credit transaction. The guaranty form varies dramatically from transaction to transaction depending on the borrower's financial strength, the borrower's and the guarantor's negotiating leverage, and the other financial accommodations the lender provides.

The form in §§6.68-6.73 is a guaranty of the borrower's performance under a promissory note, and the documents securing that performance, *i.e.*, the deed of trust, the assignment of rents, and the personal property security agreement.

The optional provisions in §§6.74-6.106 are often added and should be tailored to the particular transaction at hand.

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B. Basic Guaranty Form

§6.68 1. Form: Introduction and Recitals

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§6.68-6.106.

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6.68-1 Introduction and recitals

GUARANTY

THIS GUARANTY (Guaranty) is entered into by _ _[*name*]_ _, an individual (Guarantor), and _ _[*name*]_ _, a _ _[*entity status*]_ _ (Lender), and delivered to and in favor of Lender, as of _ _[*date*]_ _.

RECITALS

[*Add one of the following alternatives*]

[*Alternative 1: If deed of trust and assignment of rents are in the same document*]

A. _ _[*Name*]_ _ (Borrower) is entering into a Loan Agreement (Loan Agreement) dated _ _[*date*]_ _, with Lender. Under the Loan Agreement, Borrower is delivering to Lender a promissory note (Note) dated _ _[*date*]_ _, in the original principal sum of _ _[*dollar amount*]_ _. The Note is secured by a Deed of Trust, Assignment of Leases and Rents, Fixture Filing, and Security Agreement (Deed of Trust) executed by Lender as trustor in favor of Lender and dated _ _[*date*]_ _ (Deed of Trust). _ _[*Describe the credit transaction in connection with which the Guaranty is being given.*]_ _

[*Alternative 2: If deed of trust and assignment of rents are in separate documents*]

A. _ _[*Name*]_ _ (Borrower) is entering into a Loan Agreement (Loan Agreement) dated _ _[*date*]_ _, with Lender. Under the Loan Agreement, Borrower is delivering to Lender a promissory note (Note) dated _ _[*date*]_ _, in the original principal sum of _ _[*dollar amount*]_ _. The Note is secured by a deed of trust executed by Borrower as trustor in favor of Lender and dated _ _[*date*]_ _ (Deed of Trust). Borrower is also delivering to Lender an Assignment of Borrower's Interest in Leases (Assignment) dated _ _[*date*]_ _. _ _[*Describe the credit transaction in connection with which the Guaranty is being given.*]_ _

[*Continue*]

B. To induce Lender to enter into the Loan Agreement, and to accept the Note, Guarantor is delivering this Guaranty.

Comment: Although the use of recitals is optional, they are often useful in setting out the circumstances under which the guaranty is delivered, explaining the creditor's consideration and reliance and setting up the defined terms. For discussion of consideration, see §§6.14-6.15.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.69 2. Form: Guaranty Agreement

§6.69 2. Form: Guaranty Agreement

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6.69-1 Guaranty agreement

AGREEMENT

NOW, THEREFORE, in consideration of the foregoing and for other valuable consideration, the receipt and adequacy of which are hereby acknowledged, Guarantor agrees as follows:

1. Guaranty.

1.1. Guaranty of Obligations. Guarantor guarantees, to Lender, its successors, and assigns, the full and faithful payment of all amounts owed and performance of each and every one of the obligations, responsibilities, and undertakings to be carried out, performed, or observed by Borrower under the Loan Agreement, the Note, the Deed of Trust, the Assignment, any other agreement that now or later secures repayment of the Loan Agreement and the Note, and any other agreement that Guarantor now or later states is guaranteed. All these documents are collectively referred to as the "Loan Documents." The obligations guaranteed are referred to as the "Guaranteed Obligations."

1.2. Guaranty of Borrower's Performance. If at any time Borrower, its successors, or permitted assigns fails, neglects, or refuses to pay when due amounts or perform when due any of its obligations, responsibilities, or undertakings as expressly provided under the terms and conditions of the Loan Documents, then Guarantor shall pay such amounts or perform or cause to be performed such obligations, responsibilities, or undertakings as required under the terms and conditions of the Loan Documents.

Comment: For discussion of performance guaranties, see §6.17. See also the Comment to §6.71. Note that this section and §6.71 guarantee both payment of the monetary obligation and performance of the contractual provision. Such language is often heavily negotiated so that the parties' intent is clear.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.70 3. Form: Additional Credit

§6.70 3. Form: Additional Credit

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6.70-1 Additional credit

2. Additional Credit. Additional credit under the Loan Documents may be granted from time to time at Borrower's request and without further authorization from or notice to Guarantor and shall automatically be deemed part of the Guaranteed Obligations. Lender need not inquire into Borrower's power or the authority of its members, officers, or agents acting or purporting to act on its behalf. Each credit granted to Borrower under the Loan Documents shall be deemed to have been granted at Guarantor's instance and request and in consideration of, and in reliance on, this Guaranty.

Comment: This paragraph of the guaranty addresses the effect of granting additional credit to the borrower. In considering the grant of additional credit to the borrower, counsel should consider the issues raised by *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564, discussed in §6.31. In addition, incidental to the grant of additional credit, a lender will usually require an update of the financial position of the borrower and each guarantor, including new representations and warranties. For discussion of additional credit, see also §6.31.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.71 4. Form: Guaranty of Payment and Performance

§6.71 4. Form: Guaranty of Payment and Performance

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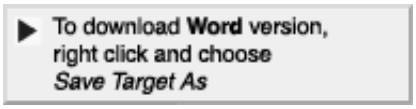

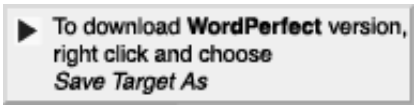

6.71-1 Guaranty of payment

3. Guaranty of Payment. Guarantor's liability on this Guaranty is a guaranty of payment and performance, not of collectibility.

Comment: This paragraph attempts to insulate the guaranty from any defects or defenses relating to the underlying loan obligation. To some extent, this is already accomplished by CC §2810, which provides that a guarantor is liable regardless of any personal disability of the borrower, even though the disability might render the underlying contract void against the borrower. The language of this provision, however, is not limited to personal liabilities. It goes further and provides that the guarantor's liability does not depend on the enforceability of the loan documents or the pursuit of remedies against the borrower.

If the loan amount is extremely large or if the guarantor is the alter ego of the borrower, lenders may add to this provision a statement that the guarantor is liable even if the loan documents are not genuine, valid, or enforceable. Understandably, most guarantors are unwilling to accept such overbroad language.

See also the provisions in §6.74, in which the guarantor agrees, among other things, that the lender may enforce the guaranty without proceeding against the borrower or exhausting the security that secures the borrower's obligation, and §6.69, in which the guarantor guarantees both payment of the note and performance of all obligations of the borrower as set forth in the loan documents.

On the distinction between payment and performance guaranty, see §6.17. See §6.18 for the limitation on damages for breach of a completion guaranty. Similar limitations may be applicable for other performance guaranties.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.72 5. Form: Cessation of Liability

§6.72 5. Form: Cessation of Liability

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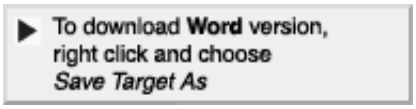

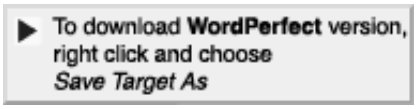

6.72-1 Cessation of liability

4. Cessation of Liability. Guarantor's liability under this Guaranty shall not in any way be affected by the cessation of Borrower's liability for any reason other than full performance of all the obligations under the Loan Documents; including, without limitation, any and all obligations to indemnify Lender.

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§6.73 6. Form: Signature

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6.73-1 Signature

IN WITNESS WHEREOF, Guarantor has executed and delivered this Guaranty as of the date first written above.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: The foregoing is a form signature block for an individual. If the guaranty is made by an entity, the signers should be appropriately described, *e.g.,* "duly authorized officers" or "duly authorized partners."

Only the guarantor(s) need sign. The lender need not sign, but it may wish to do so to demonstrate acceptance of the guaranty.

If the guaranty is executed by a partnership, to avoid any question about the authorization of the signing parties to bind the partnership, it is prudent practice to have all general partners sign the guaranty.

Generally, on larger loans, lenders will require legal opinions regarding the guarantor's authority to execute the document, due organization, and similar issues. See §§8.28-8.41.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/ C. Additional Guaranty Provisions/§6.74 1. Form: Absolute Nature of Guaranty

C. Additional Guaranty Provisions

§6.74 1. Form: Absolute Nature of Guaranty

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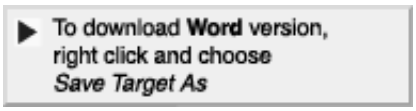

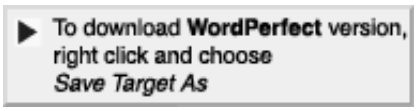

6.74-1 Absolute nature of guaranty

_. Absolute. This Guaranty is irrevocable, absolute, present, and unconditional. The obligations of Guarantor under this Guaranty shall not be affected, reduced, modified, or impaired on the happening from time to time of any of the following events, whether or not with notice to (except as notice is otherwise expressly required) or the consent of Guarantor:

_.1. Failure to Give Notice. The failure to give notice to Guarantor of the occurrence of a default under the terms and provisions of this Guaranty or the Loan Documents, as the case may be;

_.2. Modifications or Amendments. The modification or amendment (in accordance with the terms of this Guaranty or the Loan Documents) (whether material or otherwise) of any obligation, covenant, or agreement set forth in this Guaranty or Loan Documents, as the case may be;

_.3. Lender's Failure to Exercise Rights. Any failure, omission, delay by, or inability by Lender to assert or exercise any right, power, or remedy conferred on Lender in this Guaranty or the Loan Documents, as the case may be, including the failure to execute on collateral held for this Guaranty or the Loan Documents;

_.4. Release of Security. Any release of any real or personal property or other security now held or to be held by Lender for the performance of the Guaranteed Obligations;

_.5. Borrower's Termination. A termination, dissolution, consolidation, or merger of Borrower with or into any other entity;

_.6. Borrower's Bankruptcy. The voluntary or involuntary liquidation, dissolution, sale, or other disposition of all or substantially all of Borrower's assets, the marshalling of Borrower's assets and liabilities, the receivership, insolvency, bankruptcy, assignment for the benefit of creditors, reorganization, arrangement, composition with creditors, or readjustment of, or other similar proceedings affecting Borrower, Guarantor, or any of the assets of either;

_.7. Borrower's Assignment of Rights. The assignment (in accordance with the terms of this Guaranty or the Loan Documents, as the case may be) of any right, title, or interest of Lender in this guaranty or the Loan Documents to any other person; or

_.8. Extent of Guarantor's Obligations. Any other cause or circumstance, foreseen or unforeseen, whether similar or dissimilar to any of the foregoing; it being the intent of Guarantor that its obligations under this Guaranty shall not be discharged reduced, limited, or modified except by (a) payment of amounts owing pursuant to this Guaranty and/or Loan Documents, then only to the extent of such payment or payments; and (b) full performance of obligations under this Guaranty and/or Loan Documents, then only to the extent of such performed or discharged obligation or obligations.

_.9. Exercise of Lender Rights. Any action of Lender authorized pursuant to Section _ _[*e.g., form 6.76-1*]_ _ below.

Comment: This provision, stating that the guarantor's liability continues regardless of any modification of the loan documents, waiver of or failure to enforce any terms, covenants, or conditions of the loan documents, or release of any

real or personal property security, effectively waives the protections of CC §2819. See also paragraph _.2.7 in form 6.79-1, which specifically waives "any and all benefits" under several Civil Code sections, including CC §2819. For further discussion, see §§6.46-6.60.

This provision emphasizes the absolute nature of the guarantor's obligation. It supplements the "authorization" and "waiver" provisions (see §§6.76-6.79). It is often viewed as being almost duplicative of these paragraphs, however, and is often eliminated for that reason.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.75 2. Form: Maximum Liability

§6.75 2. Form: Maximum Liability

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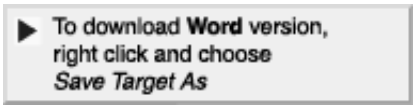

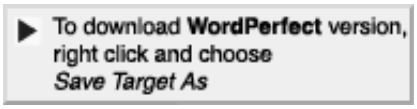

6.75-1 Maximum liability

_. Despite the foregoing terms, the maximum liability for which Guarantor shall be liable under this Guaranty shall be _ _[*dollar amount*]_ _ plus interest as specified in the Note and all costs, fees, and expenses, including, without limitation, attorney fees and costs provided for under the Note in favor of Lender.

Comment: This provision clarifies in the lender's favor the issues raised in §§6.22 and 6.29 on application of payments; the guarantor's partial payments on the loan will not reduce the maximum liability. The guarantor will be held liable on the guaranty for the entire unpaid balance of the loan up to the maximum amount.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.76 3. Form: Authorization of Lender

§6.76 3. Form: Authorization of Lender

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6.76-1 Authorization of lender

_. Authorization of Lender. Guarantor authorizes Lender, without notice or demand and without affecting its liability under this Guaranty, and without consent of Guarantor or prior notice to Guarantor, from time to time to:

_.1. Modify Loan Documents. Make any modifications to the Loan Documents;

_.2. Assign Guaranty. Assign the Loan Documents and this Guaranty;

_.3. Modify Security. Take, hold, or release security for the performance of the Guaranteed Obligations with the consent of the party providing such security;

_.4. Additional Guarantors. Accept or discharge (in whole or in part) additional guarantors;

_.5. Order of Sale. Direct the order and manner of any sale of all or any part of security now or later held under the Loan Documents or this Guaranty, and also bid at any such sale to the extent allowed by law; and

_.6. Application of Proceeds. Apply any payments or recovery from Borrower, Guarantor, or any source, and any proceeds of any security, to Borrower's obligations under the Loan Documents in such manner, order, and priority as Lender may elect, whether or not those obligations are guaranteed by this Guaranty or secured at the time of such application.

Comment: This provision is used to grant to the lender authorization to take certain actions that otherwise might result in the guarantor's exoneration. It operates much as the affirmative counterpart of the waiver section in §6.79. Occasionally, the guarantor may be able to negotiate exceptions to the authorization in paragraph _.1, such as limiting increases in principal or interest to a stated amount. See §6.50 on modifying the obligation.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/ 4. Waivers and Subordination/§6.77 a. Form: Simple Statutory Waivers

4. Waivers and Subordination

§6.77 a. Form: Simple Statutory Waivers

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6.77-1 Simple statutory waivers

_. Waivers. Guarantor waives all rights and defenses that Guarantor may have because Borrower's debt is secured by real property. This means, among other things:

_.1. No Duty to Foreclose on Security. Lender may collect from Guarantor without first foreclosing on any real or personal property collateral pledged by Borrower.

_.2. Rights If Lender Forecloses on Security. If Lender forecloses on any real property collateral pledged by Borrower:

_.2.1. The amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price.

_.2.2. Lender may collect from Guarantor even if Lender, by foreclosing on the real property collateral or electing a specific procedure for conducting that foreclosure, such as conducting a trustee's sale under the power of sale, has destroyed any right that Guarantor may have to collect from Borrower.

This is an unconditional and irrevocable waiver of any rights and defenses that Guarantor may have because Borrower's debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based on Code of Civil Procedure §580a, §580b, §580d, or §726.

Guarantor waives all rights and defenses arising from Lender's election of remedies, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a Guaranteed Obligation, has destroyed Guarantor's rights of subrogation and reimbursement against the principal by the operation of Code of Civil Procedure §580d or otherwise.

Comment: This provision of the guaranty contains waivers of a number of suretyship provisions of the Civil Code and the Code of Civil Procedure. For further discussion of these waivers, see §§6.46-6.60.

This provision also explicitly states that the exercise of certain rights and remedies under the loan documents may affect or eliminate the guarantor's subrogation rights, and it authorizes the lender to exercise these rights and remedies regardless of the impact on the borrower's rights. This is done to prevent the guarantor from claiming any estoppel defense based on the theory stated in *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64. See §§6.35-6.36 for discussion of CCP §§580a-580b; see §6.37 for discussion of CCP §580d and *Gradsky*.

These paragraphs are "model" waivers recited verbatim from CC §2856(c)-(d), which are effective for guaranties signed on or after January 1, 1997. These model waivers afford safe harbors for guaranties that might otherwise run afoul of the court's holding in *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, discussed in §6.58. For form language explaining more fully the ramifications of these waivers, see §6.78. For a more detailed list of waivers. see §6.79.

The waiver section is one of the most sensitive for lenders and guarantors. The waiver language can be short and concise, or it can be long and detailed, providing what appears to be a laundry list. Currently, the longer format is more common, because cautious lender's counsel want to avoid the possible failure to cover all laws until there is sufficient case law interpreting revised CC §2856. In any event, the vast majority of guaranties include some form of waivers

whether short or long. In addition, the waivers are often specially tailored to fit the transaction.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.78 b. Form: Special Descriptive Text

§6.78 b. Form: Special Descriptive Text

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6.78-1 Special descriptive text

_. Lender's Rights on Borrower's Default. Guarantor agrees that on Borrower's default Lender may elect to nonjudicially or judicially foreclose against any real or personal property security securing Borrower's obligations or any part of them, or accept an assignment of any such security in lieu of foreclosure, or compromise or adjust any part of such obligations, or make any other accommodation with Borrower or Guarantor, or exercise any other remedy against Borrower or any security. No such action by Lender shall release or limit Guarantor's liability to Lender, even if the effect of that action is to deprive Guarantor of the right to collect reimbursement from Borrower or any other person for any sums paid to Lender or bar or prejudice Guarantor's rights of subrogation, contribution, or indemnity against Borrower or any other person. Without limiting the foregoing, it is understood and agreed that, on any foreclosure or assignment in lieu of foreclosure of any security held by Lender, such security shall no longer exist and that any right that Guarantor might otherwise have, on full payment of the Borrower's obligations by Guarantor to Lender, to participate in any such security or to be subrogated to any rights of Lender with respect to any such security shall be nonexistent; nor shall Guarantor be deemed to have any right, title, interest, or claim under any circumstances in or to any real or personal property held by Lender or any third party following any foreclosure or assignment in lieu of foreclosure of any such security.

Comment: Occasionally, the parties to a real property transaction desire to include a more detailed explanation of the potential ramifications of the waivers. This paragraph should be used *in conjunction with* the simple waivers set forth in §6.77.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.79 c. Form: Detailed Waivers

§6.79 c. Form: Detailed Waivers

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6.79-1 Detailed waivers

_. Waivers.

_.1. Waiver of Rights to Require Lender to Act. Guarantor waives the right to require Lender to:

_.1.1. Proceed against Borrower or any other person;

_.1.2. Proceed or exhaust any security held from any person;

_.1.3. Proceed against any other guarantor; or

_.1.4. Pursue any other remedy available to Lender.

_.2. Waivers Until Obligation Is Repaid. Until the Guaranteed Obligations have been paid or otherwise discharged in full:

_.2.1. Guarantor waives all rights of subrogation, indemnity, any rights to collect reimbursement from Borrower, and any right to enforce any remedy that Lender now has, or may have, against Borrower.

_.2.2. Guarantor waives any benefit of, and any right to participate in, any security now or later held by Lender.

_.2.3. Guarantor waives any defense it may have now or in the future based on any election of remedies by Lender that destroys Guarantor's subrogation rights or Guarantor's rights to proceed against Borrower for reimbursement, and Guarantor acknowledges that it shall be liable to Lender even though Guarantor may well have no such recourse against Borrower.

_.2.4. Guarantor waives notice of (a) acceptance and reliance on this Guaranty; (b) notice of renewal, extension, or modification of any Guaranteed Obligation under this Guaranty; and (c) notice of default or demand in the case of default.

_.2.5. Guarantor waives any right or defense it may now or hereafter have based on (a) Lender's full or partial release of any party who may be obligated to Lender; (b) Lender's full or partial release or impairment of any collateral for the Guaranteed Obligations; and (c) the modification or extension of the Guaranteed Obligations.

_.2.6. Guarantor waives any and all suretyship defenses now or later available to it under the California Civil Code or the California Commercial Code.

_.2.7. Without limiting the generality of any other waiver or provision of this Guaranty, Guarantor waives, to the maximum extent such waiver is permitted by law, any and all benefits or defenses arising directly or indirectly under any one or more of (a) California Civil Code §§2799, 2808, 2809, 2810, 2815, 2819, 2820, 2821, 2822, 2838, 2839, 2845, 2846, 2847, 2848, 2849, 2850, 2899, and 3433; (b) Chapter 2 of Title 14 of the California Civil Code; (c) California Code of Civil Procedure §§580a, 580b, 580c, 580d, and 726; or (d) California Commercial Code §3605.

_.2.8. Guarantor waives any statute of limitation affecting liability under this Guaranty or the enforceability of this Guaranty and further waives any defense that might otherwise exist because of the expiration of the

statute of limitations on the Loan Documents.

_.2.9. Guarantor waives any duty of Lender to disclose to Guarantor any facts Lender may now know or later learn about Borrower or Borrower's financial condition regardless of whether Lender has reason to believe that any such facts materially increase the risk beyond that which Guarantor intends to assume, or has reason to believe that such facts are unknown to Guarantor, or has a reasonable opportunity to communicate such facts to Guarantor, it being understood and agreed that Guarantor is fully responsible for and is capable of being and keeping informed of Borrower's financial condition and of all circumstances bearing on the risk of nonpayment of any indebtedness guaranteed under this Guaranty.

_.2.10. Guarantor waives all notices to Guarantor.

Comment: Lenders often prefer to have an extensively detailed list of waivers. This provision is thorough but even this listing has been used in conjunction with the special descriptive text in §6.78.

In this provision, the guarantor waives several statutory protections that could potentially limit the guarantor's liability under the guaranty. The waiver of diligence and demand of payment in subparagraph _.1 restates the provisions of CC §2807. Subparagraph _.2.4. waives all notices, including notices of any alterations or obligations. See §6.30. Subparagraph _.2.8. waives any applicable statute of limitations.

Subparagraph _.2.9. waives certain disclosure requirements established by the California Supreme Court in *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564. Despite this waiver, lenders should disclose to the guarantor any material fact of which they are aware to avoid any future defenses by the guarantor of estoppel, waiver, bad faith, or fraud.

Subparagraph _.2.6. is a catchall waiver of any legal or equitable defenses. It is unknown whether a waiver of an unspecified defense is enforceable.

Subparagraph _.2.7. identifies in detail the principal statutes that provide defenses to a guarantor.

Although the Civil Code sections waived by this provision (CC §§2845, 2849-2850) are also waived by the provisions in §6.77, waivers of any substantial rights should be specifically described, in addition to waivers referring to Civil Code section numbers, to help ensure that the guarantor is aware of the rights it is waiving.

PRACTICE TIP: Lender's counsel should consider providing the guarantor copies of the cited statutes, particularly if the guarantor is unrepresented. Doing so will reduce the risk of the guarantor's claiming ignorance of the rights waived.

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§6.80 5. Form: Subordination

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6.80-1 Subordination

_. Subordination. Until the Guaranteed Obligations have been paid or otherwise discharged in full, Guarantor subordinates any and all liability or indebtedness of Borrower owed to Guarantor to the obligations of Borrower to Lender that arise under the Guaranteed Obligations. However, Guarantor may receive payment of current reasonable salary and current reasonable payments made in the ordinary course of business for goods provided or services rendered.

Comment: This provision merely subordinates the guarantor's rights for reimbursement and indemnity from the borrower until the creditor has been repaid in full. For further discussion of the impact of bankruptcy, see §§6.62-6.64.

In addition to the waivers specified in §§6.77-6.79, the lender often requires the guarantor to affirmatively subordinate its rights. These provisions are designed to give the lender rights to performance from the borrower that are superior to any rights that the guarantor may have against the borrower. The limitation on and subordination of the guarantor's rights remain in effect as long as the borrower's obligations to the lender under the loan documents remain unsatisfied. In the first sentence of this provision, the guarantor agrees, in effect, that partial performance of any of the borrower's obligations does not give rise to any right of the guarantor to be subrogated to the rights of or to enforce any remedy of the lender.

Lenders often require guaranties from parent corporations (guaranteeing the obligations of subsidiaries) and from principal shareholders and officers of a corporation. Borrowers often owe money to these same parent companies and principal shareholders, either as a result of previous loans or other monetary undertakings or obligations, or as a result of salary obligations to the shareholder/officers. Therefore, exceptions are often negotiated, generally relating to the maintenance of specific financial covenants. In the second sentence of this provision, the lender permits the borrower to pay the guarantor absent a default. Any exceptions should be specific and carefully delineated. See discussion in §6.44 on alter egos and corporate guaranties by parents or subsidiaries.

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§6.81 6. Form: Bankruptcy

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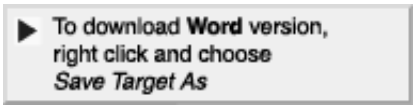

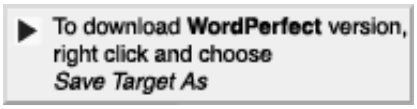

6.81-1 Bankruptcy

_. Effect of Borrower's Bankruptcy. The liability of Guarantor under this Guaranty shall in no way be affected by:

_.1. Release of Borrower. Release or discharge of Borrower in any creditor proceeding, receivership, bankruptcy, or other proceeding;

_.2. Modification of Borrower's Liability. Impairment, limitation, or modification of Borrower's liability or the estate, or of any remedy for the enforcement of Borrower's liability, which may result from the operation of any present or future provision of the Bankruptcy Code (Title 11 of the United States Code, as amended; 11 USC §§101-1532) or any bankruptcy, insolvency, debtor relief statute (state or federal), any other statute, or from the decision of any court;

_.3. Rejection of Debt. Rejection or disaffirmance of the indebtedness, or any portion of the indebtedness, in any such proceeding; or

_.4. Cessation of Borrower's Liability. Cessation, from any cause whatsoever, whether consensual or by operation of law, of Borrower's liability to Lender resulting from any such proceeding.

_.5 Modification and Replacement of Guaranteed Obligation. If the Guaranteed Obligations are restructured or replaced in connection with a bankruptcy proceeding or case, Guarantor shall remain liable as guarantor of such restructured or replaced obligation.

Comment: Guaranties often include a statement that bankruptcy or similar laws do not adversely affect liability under the guaranty.

This provision basically states that the guarantor's liability is to be unaffected by bankruptcy or other creditor proceedings of or against the borrower, thereby minimizing the possibility of complex issues concerning the guarantor's liability under 11 USC §502(e). See §6.66.

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§6.82 7. Form: Claims in Bankruptcy

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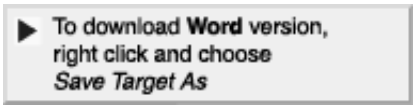

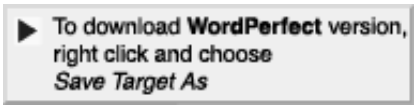

6.82-1 Claims in bankruptcy

_. Claims in Bankruptcy. Guarantor shall file all claims against Borrower in any bankruptcy or other proceeding in which the filing of claims is required or allowed by law on any indebtedness of Borrower to Guarantor, and shall assign to Lender all rights of Guarantor on any such indebtedness. If Guarantor does not file any such claim, Lender, as attorney-in-fact for Guarantor, is authorized to do so in Guarantor's name, or, in Lender's discretion, to assign the claim and to file a proof of claim in the name of Lender's nominee. In all such cases, whether in bankruptcy or otherwise, the person or persons authorized to pay such claim shall pay to Lender the full amount of any such claim, and, to the full extent necessary for that purpose, Guarantor assigns to Lender all of Guarantor's rights to any such payments or distributions to which Guarantor would otherwise be entitled.

Comment: This provision is designed to ensure that any of the guarantor's claims against the borrower are asserted in a bankruptcy action and that the benefits from it inure to the lender's benefit.

This provision places the burden of filing claims in bankruptcy on the guarantor, assigns the proceeds of any such claims to the lender, and authorizes the holder to file claims in the guarantor's name if the guarantor fails to do so. The guarantor may wish to clarify that any assignment is only for as long as and to the extent that the lender has not been paid in full.

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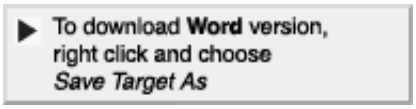
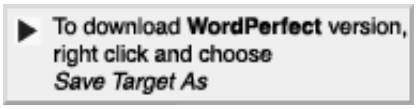
§6.83 8. Form: Application of Payments and Refunds

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§6.68-6.106.





6.83-1 Application of payments and refunds

_. Application of Payments. With or without notice to Guarantor, Lender, in its sole discretion and at any time and from time to time and in such manner and on such terms as it deems fit may:

_.1. Priority of Payments. Apply any or all payments or recoveries from Borrower, from Guarantor, or from any other guarantor or endorser under this or any other instrument, or realized from any security, in such manner, order, or priority as Lender sees fit, to the indebtedness of Borrower to Lender under the Loan Documents, whether such indebtedness is guaranteed by this Guaranty or is otherwise secured or is due at the time of such application; and

_.2. Refund to Borrower. Refund to Borrower any payment received by Lender on any indebtedness guaranteed in this Guaranty, and payment of the amount refunded is fully guaranteed. Any recovery realized from any other guarantor under this or any other instrument shall be first credited on that portion of the indebtedness of Borrower to Lender that exceeds the maximum liability, if any, of Guarantor under this Guaranty.

Comment: This paragraph basically gives the lender complete flexibility in applying any payments received, realized, or recovered (by way of foreclosure or otherwise) from any and all sources, including the guarantor, any other guarantor, the borrower, or any security securing the indebtedness. To the extent any maximum limitation has been placed on the amount of guarantor's exposure, this provision provides that a recovery against any other guarantor shall first be applied against that portion of the indebtedness that exceeds the guarantor's maximum liability.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.84 9. Form: Representations and Warranties

§6.84 9. Form: Representations and Warranties

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6.84-1 Representations and warranties

__. Representations and Warranties. Guarantor represents and warrants to Lender that:

[*Add one of the following alternatives*]

[*Alternative 1: Corporation or other entity*]

__.1. Legal Status. Guarantor (a) is a _ _[*entity status, e.g., corporation*]**_ _ duly organized and validly existing under the laws of the State of _ _**[*name*]**_ _; (b) has all requisite power, and has all material governmental licenses, authorizations, consents, and approvals necessary to own its assets and carry on its business as now being or as proposed to be conducted; and (c) is qualified to do business in the State of California.**

__.2. No Breach. Neither the execution and delivery of this Guaranty nor compliance with its terms and provisions shall conflict with or result in a breach of, or require any consent under, the organizational documents of Guarantor, or any agreement or instrument by which Guarantor is bound.

__.3. Authority and Power. Guarantor has all necessary power and authority to execute, deliver, and perform its obligations under this Guaranty. Guarantor's execution, delivery, and performance of this Guaranty has been duly authorized by all necessary action on its part; and this Guaranty has been duly and validly executed and delivered by Guarantor and constitutes its legal, valid, and binding obligation, enforceable against Guarantor in accordance with its terms. Guarantor shall, concurrently with the execution of this Guaranty, deliver to Lender a copy of a _ _[*resolution of Guarantor's e.g., members*]**_ _ authorizing or ratifying execution of this Guaranty.**

__.4. Liquidity. Guarantor has a tangible net worth (determined on a fair market value of assets basis, after payment of any and all liabilities now or hereafter payable and after establishment of adequate reserves for contingent liabilities and taxes on unrealized gains) in excess of _ _[*dollar amount*]**_ _.**

[*Alternative 2: Individual*]

__.1 Legal Status. Guarantor _ _[*name*]**_ _ has all requisite power and has all material governmental licenses, authorizations, consents, and approvals necessary to carry on _ _**[*his/her*]**_ _ business as now being or as proposed to be conducted.**

__.2. No Breach. Neither the execution and delivery of this Guaranty nor compliance with its terms and provisions shall conflict with or result in a breach of, or require any consent under any agreement or instrument by which Guarantor is bound.

__.3. Authority and Power. This Guaranty has been duly and validly executed and delivered by Guarantor and constitutes its legal, valid, and binding obligation, enforceable against Guarantor in accordance with its terms.

__.4. Liquidity. Guarantor has a tangible net worth (determined on a fair market value of assets basis, after payment of any and all liabilities now or hereafter payable and after establishment of adequate reserves for contingent liabilities and taxes on unrealized gains) in excess of _ _[*dollar amount*]**_ _.**

__.5. Financial Statements. All financial information furnished or to be furnished to lender is or will be true and correct, does or will fairly represent the financial condition of Guarantor, and was or will be prepared in accordance with policy accepted accounting principles.

__.6. Claims and Proceedings. There are no claims, actions, proceedings, or investigations pending against Guarantor.

Comment: Many guaranties do not include any representations and warranties. Representations in conjunction with the recitals, however, can be used by the lender to establish various basic facts the lender relied on in entering into the guaranty arrangement. In particular, they are useful for the lender in establishing whether the guarantor would later be able to assert a defense that the guarantor was the borrower's alter ego. If the lender requires these representations, it is difficult for the guarantor to refuse to give them because it would automatically raise serious red flags for the lender.

As additional protection, lenders frequently require opinions of counsel for further protection. See chap 8.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.85 10. Form: Information

§6.85 10. Form: Information

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6.85-1 Information

__. Information Not Required. Guarantor represents that Guarantor is fully aware of Borrower's financial condition and operation and is in a position by virtue of _ _[*his/her/its*]_ _ relationship to Borrower to obtain all necessary financial and operational information concerning Borrower. Lender need not disclose to Guarantor any information about:

__.1. Loan Documents. The Loan Documents or any modification of them, and any action or nonaction in connection with them;

__.2. Other Guaranteed Obligations. Any other obligation guaranteed in this Guaranty;

__.3. Borrower's Financial Condition. The financial condition or operation of Borrower; or

__.4. Other Guarantors. Any other guarantors.

Comment: To minimize the need to provide the guarantor with information on the borrower or the loan when the guarantor is an insider of borrower, many guaranties contain provisions similar to those in the first paragraph.

This provision supplements the waivers in paragraph _.2.9. in §6.79 relating to defenses arising under *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564. See §6.31.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.86 11. Form: Partner Liability

§6.86 11. Form: Partner Liability

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6.86-1 Partner liability

__. Partner Liability.

__.1. Joint and Several Liability. Each and every present and future general partner of Guarantor is and shall remain jointly and severally liable for all Guaranteed Obligations irrespective of when and how such obligations arose and irrespective of any Statements of Authority or any statements of denial that may have been filed;

__.2. Modifies Partnership Agreement. This provision modifies and supplements any and all partnership agreements in effect regarding Guarantor;

__.3. Enforcement of Guaranty. On a default under any Guaranteed Obligation, Lender may at any time enforce this Guaranty and file suit against any or all partners of Guarantor either concurrent with or independent of enforcement against Guarantor. A judgment creditor of a partner may at any time levy execution against any partner or the partner's assets to enforce a judgment based on a claim against Guarantor, and shall not be required in any way to pursue Guarantor or its assets. As regards such a judgment, each partner waives the protections provided under Corporations Code §16307(c)-(d).

Comment: If the guarantor is a partnership or a limited liability partnership, the lender may wish to make certain that all partners are obligated and that its remedies against the partners are not limited by RUPA.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.87 12. Form: Revival of Guaranty

§6.87 12. Form: Revival of Guaranty

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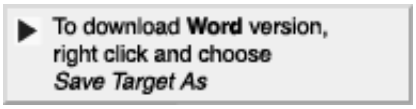

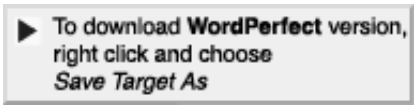

6.87-1 Revival of guaranty

__. Revival of Guaranty. If a claim (Claim) is made on Lender at any time (whether before or after payment or performance in full of any Guaranteed Obligation, and whether such claim is asserted in a bankruptcy proceeding or otherwise) for repayment or recovery of any amount or other value received by Lender (from any source) in payment of, or on account of, any Guaranteed Obligation and if Lender repays such amount, returns value or otherwise becomes liable for all or part of such Claim by reason of (a) any judgment, decree, or order of any court or administrative body or (b) any settlement or compromise of such Claim, Guarantor shall remain severally liable to Lender for the amount so repaid or returned or for which Lender is liable to the same extent as if such payments or value had never been received by Lender, despite any termination of this Guaranty or the cancellation of any note or other document evidencing any Guaranteed Obligation.

Comment: The lender will want the guaranty to automatically revive if any consideration paid by the borrower will be recaptured in, for example, a borrower's bankruptcy.

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§6.88 13. Form: Waiver of Jury Trial

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6.88-1 Waiver of jury trial

__. WAIVER OF JURY TRIAL. LENDER AND GUARANTOR WAIVE, TO THE EXTENT PERMITTED BY APPLICABLE LAW, TRIAL BY JURY IN ANY LITIGATION OR PROCEEDING WITH RESPECT TO, IN CONNECTION WITH, OR ARISING FROM THIS GUARANTY OR THE LOAN DOCUMENTS, OR ANY INSTRUMENT OR DOCUMENT DELIVERED IN CONNECTION WITH THIS GUARANTY OR THE TRANSACTIONS CONTEMPLATED HERE, OR THE GUARANTY'S VALIDITY, PROTECTION, INTERPRETATION, COLLECTION, OR ENFORCEMENT, OR ANY OTHER CLAIM OR DISPUTE HOWSOEVER ARISING (INCLUDING TORT AND CLAIMS FOR BREACH OF DUTY) BETWEEN LENDER AND GUARANTOR.

Comment: Lenders are usually averse to having a jury trial; some lenders insist that the guarantor agree to binding arbitration; others, as a compromise, insist that the guarantor agree to a waiver of the right to a jury trial. But in 2005, the California Supreme Court ruled that contractual predispute jury waivers are unenforceable. See *Grafton Partners LP v Superior Court* (2005) 36 C4th 944, 32 CR3d 5, discussed in §§3.103, 4.58. By contrast, the California Supreme Court has held that a predispute agreement to arbitrate is generally enforceable. *Madden v Kaiser Found. Hosps.* (1976) 17 C3d 699, 131 CR 882.

The Federal Arbitration Act (9 USC §§1-16) preempts some but not all state law procedures that govern the enforcement of arbitration clauses. See, *e.g., Armendariz v Foundation Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 99 CR2d 745. See also cases discussed in California Real Property Remedies and Damages, chap 14 (2d ed Cal CEB 2002).

Although the validity of arbitration and judicial reference provisions was generally recognized by the supreme court in *Grafton Partners LP v Superior Court, supra,* their enforceability must be determined on a case-by-case basis when challenged on the ground of unconscionability. See, *e.g., Trend Homes, Inc. v Superior Court* (2005) 131 CA4th 950, 32 CR3d 411; *Greenbriar Homes Communities, Inc. v Superior Court* (2004) 117 CA4th 337, 11 CR3d 371; *Villa Milano Homeowners Ass'n v Il Davorge* (2000) 84 CA4th 819, 102 CR2d 1, and authorities cited therein.

PRACTICE TIP: Lenders desiring to avoid litigation in court, and jury trials in particular, should consider adding an arbitration or judicial reference provision. See §4.115. In drafting these provisions, counsel should consider using bold type and requiring the parties to initial the arbitration clause. Counsel should also compare and consider the actual differences among reported cases, such as *Trend Homes, Greenbriar Homes Communities,* and *Villa Milano Homeowners Ass'n*.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.89 14. Form: Submission to Jurisdiction

§6.89 14. Form: Submission to Jurisdiction

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6.89-1 Submission to jurisdiction

__. Submission to Jurisdiction. Guarantor irrevocably submits to the nonexclusive jurisdiction of the United States District Court for the _ _[*name of district*]_ _ and of any _ _[*state*]_ _ court sitting in _ _[*city*]_ _ for any and all legal proceedings arising from or relating to this Guaranty and the Loan Documents.

Comment: Another procedural provision is often added to guaranties in order to allow the lender to sue both the guarantor and the borrower in the same forum and in one convenient for the lender.

NOTE: Clauses establishing *venue* have been held invalid as against public policy. *Alexander v Superior Court* (2003) 114 CA4th 723, 8 CR3d 111. In *Alexander*, the court distinguished between a *forum* selection clause (choosing a court or place of jurisdiction) and a *venue* selection clause (choosing the place within the jurisdiction where the case may be heard) and concluded that private parties could not override the legislature's statutory scheme for determining which court was appropriate for handling a case. See also *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 496, 131 CR 374 (forum selection clause not per se invalid). Under *Alexander*, the choice of federal court or state court would be respected, but a designation of Los Angeles versus San Francisco Superior Court would be invalid.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.90 15. Additional Miscellaneous Clauses

§6.90 15. Additional Miscellaneous Clauses

The additional provisions in §§6.91-6.106 are often considered to be boilerplate but parties drafting them should give these paragraphs a good deal of thought. Few guaranties include all of these provisions.

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§6.91 a. Form: Notice

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6.91-1 Notice

42. Notice. Except for any notice required by Governmental Requirements to be given in another manner, (a) all notices required or permitted by this Guaranty shall be in writing; (b) each notice to Guarantor shall be sent (i) for personal delivery by a delivery service that provides a record of the date of delivery, the individual to whom delivery was made, and the address where delivery was made; (ii) by certified United States mail, postage prepaid, return receipt requested; or (iii) by nationally recognized overnight delivery service, marked for next-business-day delivery; and (c) all notices shall be addressed to the appropriate party at its address as follows or such other addresses as may be designated by notice given in compliance with this provision:

Lender: _____
_____
_____

Guarantor: _____
_____
_____

Notices will be deemed effective on the earliest of (a) actual receipt; (b) rejection of delivery; or (c) if sent by certified mail, the third day on which regular United States mail delivery service is provided after the day of mailing or, if sent by overnight delivery service, on the next day on which such service makes next-business-day deliveries after the day of sending.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.92 b. Form: No Waiver

§6.92 b. Form: No Waiver

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6.92-1 No waiver

__. No Waiver. No failure or delay by Lender or its assigns in exercising any right, power, or privilege under this Guaranty shall operate as a waiver; nor shall any single or partial exercise of any right, power, or privilege preclude any other or further such exercise or the exercise of any other right, power, or privilege.

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§6.93 c. Form: California Law

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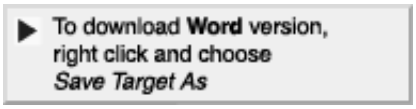

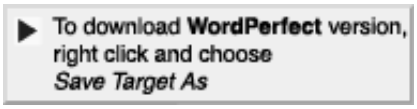

6.93-1 California law

__. California Law. This Guaranty shall be governed by and construed in accordance with the internal laws of the State of California.

Comment: See §§3.48, 4.55 for discussion of choice-of-law issues.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.94 d. Form: Advice of Counsel

§6.94 d. Form: Advice of Counsel

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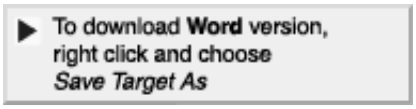

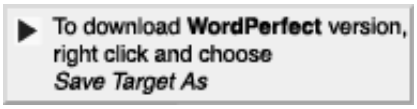

6.94-1 Advice of counsel

__. Advice of Counsel. Guarantor expressly declares that it knows and understands the contents of this Guaranty and has _ _[*consulted/had an opportunity to consult*]**_ _ with an attorney as to its form and content.**

Comment: This provision is important for the lender. Courts are more willing to enforce waivers in a guaranty if the guarantor signed the documents with the advice of counsel. Guarantor's counsel should be identified in the document and approve the guaranty as to its form.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.95 e. Form: Attorney Fees

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6.95-1 Attorney fees

__. Attorney Fees. Whether or not legal action is commenced, dismissed, or pursued to judgment, the prevailing party shall be entitled to payment of all fees and costs (including, without limitation, attorney fees and costs) that may be incurred by such party in connection with the enforcement of this Guaranty, the enforcement of any of the Loan Documents, and the protection of prevailing party's rights under this Guaranty or under the Loan Documents (whether in state, federal, or Bankruptcy Court proceedings).

In addition to the aforementioned fees, costs, and expenses, the prevailing party in any lawsuit on this Guaranty shall be entitled to its attorney fees, and all other fees, costs, and expenses incurred in any postjudgment proceedings to collect or enforce any judgment. This provision for the recovery of postjudgment fees, costs, and expenses is separate and several and shall survive the merger of this Guaranty into any judgment on this Guaranty.

Comment: Civil Code §1717 imposes a mutuality requirement that the prevailing party may recover attorney fees under a contractual provision relating to attorney fees, regardless of whether that party was specified in the attorney fees provision of the contract.

The language in the second paragraph creates a contractual provision allowing fees, costs, and expenses to be recovered, and it preserves the right to recover postjudgment fees, costs, and expenses incurred in enforcing a judgment.

For further discussion of attorney fees, see §§6.23-6.25.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.96 f. Form: Assignability

§6.96 f. Form: Assignability

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6.96-1 Assignability

__. Assignability. This Guaranty shall be binding on Guarantor and Guarantor's heirs, representatives, successors, and assigns and shall inure to the benefit of Lender, its successors and assigns, and their successors and assigns and respective personal representatives, successors, and assigns according to the context of this Guaranty. Guarantor shall not have the right to assign the obligations in this Guaranty. Lender may assign its rights under this Guaranty in connection with an assignment of all or part of the Guaranteed Obligation. Notice is hereby waived as to any such assignment by Lender.

Comment: Current law is unclear whether a guaranty can be assigned without the guarantor's consent if the lender assigns the guaranteed obligation. This provision is intended to clarify that situation in the lender's favor. Division 9 of the California Commercial Code, which is California's version of Article 9 of the Uniform Commercial Code, automatically allows the assignment of a guaranty as a "supporting obligation." See Com C §9203(f).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.97 g. Form: Joint and Several Liability

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6.97-1 Joint and several liability

__. Joint and Several. If this Guaranty is issued by more than one party or if any other party guarantees the obligations of Borrower, the obligations of Guarantor and any others under this Guaranty shall be joint and several.

Comment: The provision is included to rebut the presumption of CC §1431 that obligations imposed on a number of persons are joint and not several.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.98 h. Form: Captions

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6.98-1 Captions

__. Captions. The captions and section headings appearing in this Guaranty are included solely for convenience of reference and are not intended to affect the interpretation of any provision of this Guaranty.

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§6.99 i. Form: Severability

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6.99-1 Severability

__. Severability. If any provision in this Guaranty is invalid and unenforceable in the jurisdiction whose law is applied to this Guaranty or in any particular context, then, to the fullest extent permitted by law, (a) the other provisions shall remain in full force and effect in such jurisdiction or context and shall be liberally construed in favor of Lender in order to carry out the parties' intentions as nearly as possible, and (b) the invalidity or unenforceability of any provision in that jurisdiction or context shall not affect the validity or enforceability of such provision in any other jurisdiction.

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§6.100 j. Form: Entire Agreement

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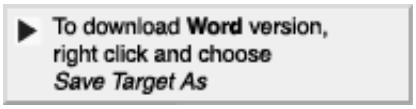

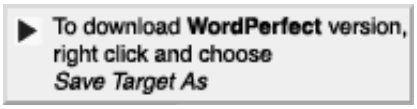

6.100-1 Entire agreement

__. Entire Agreement. This Guaranty embodies the entire agreement and understanding between Guarantor and Lender pertaining to the subject matter of this Guaranty, and supersedes all prior agreements, understandings, negotiations, representations, and discussions, whether verbal or written, of the parties, pertaining to that subject matter. Guarantor is not relying on any representations, warranties, or inducements from Lender that are not expressly stated in this Guaranty.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/6 The Guaranty/§6.101 k. Form: Further Assurances

§6.101 k. Form: Further Assurances

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6.101-1 Further assurances

__. Further Assurances. Guarantor shall promptly and duly execute and deliver to Lender such further documents and assurances and take such further action as Lender may from time to time reasonably request, including, without limitation, any amendments to this Guaranty to establish and protect the rights, interests, and remedies created or intended to be created in favor of Lender.

Comment: This provision often proves useful because the lender cannot always anticipate all future conditions.

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§6.102 I. Form: Gender and Number

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6.102-1 Gender and number

__. Gender; Singular Includes Plural. As used in this Guaranty, the singular includes the plural, and the masculine includes the feminine and neuter, and vice versa, if the context so requires.

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§6.103 m. Form: Nonwaiver

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6.103-1 Nonwaiver

__. Nonwaiver. No provision of this Guaranty or right of Lender under this Guaranty can be waived, nor can Guarantor be released from its obligations under this Guaranty except by a writing duly executed by an authorized representative of Lender.

Comment: Despite this provision, a waiver of a right that has been completed de facto is effective even though it has not been memorialized in a signed document.

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§6.104 n. Form: Continuing Liability

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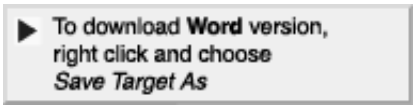

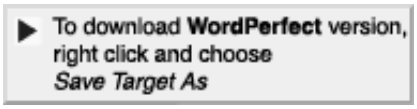

6.104-1 Continuing liability

__. Continuing Liability. Guarantor shall continue to be liable under this Guaranty despite the transfer by Borrower of all or any portion of the property encumbered by the Loan Documents.

Comment: This provision makes it clear that, even if the guarantor's initial guaranty was given with a specific borrower in mind, a transfer of all or any portion of the encumbered property to another shall not serve to affect or otherwise alter the guarantor's obligations.

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§6.105 o. Form: Time of Essence

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6.105-1 Time of essence

__. Time Is of the Essence. Time is of the essence under this Guaranty and any amendment, modification, or revision of this Guaranty.

Comment: For a more detailed time is of the essence provision, see paragraph 49.6 in 4.114-1.

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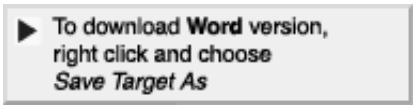

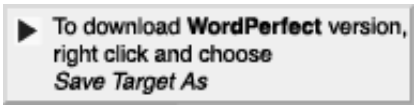

6.106-1 Cumulative rights

__. Cumulative Rights. The extent of Guarantor's liability and all rights, powers, and remedies of Lender under this Guaranty, and under any other agreement now or at any future time in force between Lender and Guarantor, shall be cumulative and not alternative, and such rights, powers, and remedies shall be in addition to all rights, powers, and remedies given to Lender by law. This Guaranty is in addition to and exclusive of the guaranty of any other guarantor of any indebtedness of Borrower to Lender.

Comment: This provision is important to clarify the fact that the lender has all rights permitted by law under the guaranty and all related documents whether or not those rights are specifically enumerated in the guaranty.

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7

Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9

Michael T. Andrew

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I. INTRODUCTION

§7.1 A. Scope of Chapter

Virtually all commercial real property loan transactions—whether they involve office buildings, hotels, retail property, apartments, or even land for development—also potentially involve personal property collateral. This may include tangible property (*e.g.,* furnishings and equipment), intangible property (*e.g.,* operating agreements, operating names, personal property leases, and development and other contracts), and hybrids (*e.g.,* plans, drawings, specifications, and computer software, which take tangible form but may also represent or embody intangible intellectual property).

This chapter addresses negotiation, documentation, and perfection issues raised when personal property is included as part of a real property lender's collateral in a commercial transaction. The chapter focuses on two documents normally essential to a valid and perfected security interest in such personal property:

- The security agreement (a contractual document); and
- The financing statement (a notice document filed with a public office, such as a Secretary of State's office).

The creation, perfection, priority, and enforcement of security interests in personal property are the subject of Division 9 of the California Commercial Code, which is California's version of Article 9 of the Uniform Commercial Code, as revised effective July 1, 2001. For more extensive treatment of all these topics, see Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001). See also California Mortgages, Deeds of Trust, and Foreclosure Litigation §§9.12-9.23 (4th ed Cal CEB 2009) (discussing enforcement of mixed real and personal property collateral transactions) and Ebling & Weise, *What a Dirt Lawyer Needs to Know About New Article 9 of the UCC*, 37 Real Prop Prob & Tr J 191 (Summer 2002).

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§7.2 B. Revised California Commercial Code Division 9

In 1998 the National Conference of Commissioners on Uniform State Laws and the American Law Institute promulgated an extensively revised version of UCC Article 9 (further modified in 2000). Most of the fundamental concepts of prior law were retained, but many changes were made to the law's scope, structure, and substance, and to the rules for perfecting security interests.

California adopted revised UCC Article 9 (with a few nonuniform changes) as Division 9 of the California Commercial Code, effective July 1, 2001. Com C §9701. All references to "Com C" in this chapter are to the revised Code. Former Division 9 is cited as "former Com C."

Revised UCC Article 9, with various nonuniform changes, has been adopted and is effective in all 50 states (most with an effective date of July 1, 2001, a few with an effective date as late as January 1, 2002). As discussed in §7.34, because of revised rules governing the proper state in which to file a financing statement, Article 9 as adopted in other states will now often be relevant in California transactions. For an extensive state-by-state survey of nonuniform enactments of Article 9, see Christophorou, Kettering, Soukup, & Weise, *Under the Surface of Revised Article 9: Selected Variations in State Enactments from the Official Text of Revised Article 9*, 34 UCC LJ 331 (Spring 2002).

The revised statute applies not only to transactions entered into after its effective date, but also to pre-effective-date transactions, subject to transition rules set out in Com C §§9701-9709. The principal transition rules likely to be relevant to a real estate lender are summarized in §7.42.

For comparisons of the current and former versions of Article 9, see Weise, *A Comparison of a Security Agreement Under the Current Article 9 and the New Article 9,* 32 UCC LJ 300 (2000); Weise, *A Comparison of the Current Article 9 and the New Article 9,* 32 UCC LJ 270 (2000).

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C. Terminology

§7.3 1. Parties

The Commercial Code uses its own terminology to refer to the principal parties in a Division 9 secured transaction:

- The party in whose favor the security interest is created is the "secured party." Com C §9102(a)(72).
- A party who owns (or has an interest other than a security interest in) the collateral is a "debtor." Com C §9102(a)(28).
- A party who owes payment or performance of the secured obligation, who may or may not also be a debtor, is an "obligor." Com C §9102(a)(59).
- An obligor whose obligation is secondary is a "secondary obligor." Com C §9102(a)(71).

On how debtors, obligors, and secondary obligors are treated differently in the enforcement of security interests, see Secured Transactions in California Commercial Law Practice, chap 5 (2d ed Cal CEB 2001); UCC §9-102 Official Comment 2a.

The borrower in a typical real property secured loan transaction, typically referred to as the "trustor" or "mortgagor" in real estate parlance, will usually be both the "debtor" and the "obligor" in Commercial Code terminology. The lender, known in the real estate context as the "beneficiary" or "mortgagee," will be the Commercial Code "secured party." In this chapter, references to "borrower" and "lender" are used interchangeably with the Code's "debtor" and "secured party" terminology, respectively.

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§7.4 2. Authenticated Records

One of revised Article 9's innovations is its recognition that "[g]iven the rapid development and commercial adoption of modern communication and storage technologies, requirements that documents or communications be 'written,' 'in writing,' or otherwise in tangible form do not necessarily reflect or aid commercial practices." UCC §9-102 Official Comment 9a. Thus, in most respects the revised statute is "medium neutral," authorizing and recognizing security agreements and financing statements in or on media other than paper.

Two defined terms are central to that approach:

- **Record.** In most contexts in which prior law required a "writing" or a "written" document, the revised law requires a "record." A record is "information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form." Com C §9102(a)(69). UCC §9-102 Official Comment 9a provides further guidance:

  > A "record" need not be permanent or indestructible, but the term does not include any oral or other communication that is not stored or preserved by any means. The information must be stored on paper or in some other medium. Information that has not been retained other than through human memory does not qualify as a record. Examples of current technologies commercially used to communicate or store information include, but are not limited to, magnetic media, optical discs, digital voice messaging systems, electronic mail, audio tapes, and photographic media, as well as paper.

- **Authenticate.** While prior law contemplated that a "writing" would be "signed," the revised statute provides that a "record" will be "authenticated." To authenticate means "to sign" or "to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept the record." Com C §9102(a)(7). (In the context of financing statements, the statute goes even a step further, eliminating altogether any requirement of a signature or other authentication by the debtor. See §7.31.)

As a practical matter, the personal property element of most real estate secured loans will likely remain paper-based for some time (except for electronic filing of financing statements where permitted). Frequent references to "documents" in this chapter recognize that reality but are not meant to suggest that tangible documents are the only possibility.

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§7.5 3. Collateral

"Collateral" means the property subject to a security interest. Com C §9102(a)(12). Division 9 categorizes collateral into several types (*e.g.,* "goods," "accounts," "general intangibles"), each with its own specialized definition, and many Division 9 rules apply differently to different types of collateral. See Secured Transactions in California Commercial Law Practice, chap 1 (2d ed Cal CEB 2001). Types of personal property collateral frequently encountered in real estate secured transactions, and the differing perfection rules for each, are discussed in §§7.23-7.30.

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II. CREATION OF SECURITY INTEREST; THE SECURITY AGREEMENT

A. Types of Security Agreement

§7.6 1. Separate Security Agreement Versus Combined Deed of Trust/Security Agreement

A security agreement, in the form of an authenticated record (see §7.4), is necessary to create an enforceable security interest in most personal property not in the secured party's possession or control. Com C §9203(b)(3)(A). As discussed in §§7.8-7.12, a security agreement must, by statute, contain three elements:

- Grant of (or provision for) the security interest—*i.e.,* an interest in personal property securing an obligation;
- Description of the collateral; and
- Authentication by the debtor.

As long as those required elements are present, there is no requirement that a security agreement be a separate, stand-alone document. Thus, in real estate loan transactions it is now common practice to include all of the normal content of a security agreement in the deed of trust, eliminating the need for a separate personal property security agreement. The form deed of trust in §§4.62-4.118 is an example of a combined deed of trust/security agreement. This approach brings together all of the collateral-related aspects of the loan transaction in one place, making it easier to closely coordinate them, minimize duplication, and avoid gaps and inconsistent provisions.

When an institutional lender makes the loan, the lender likely dictates whether to use a separate security agreement based on the lender's customary practice. Most institutional lenders now use a combined form of deed of trust, fixture filing, and security agreement (at least for most common types of personal property collateral). With carefully drafted and coordinated documents, either approach can be equally effective and acceptable to both lender and borrower.

The security agreement form presented and discussed in this chapter is a separate agreement from the deed of trust. It would not be used in a transaction in which a deed of trust such as the form in chap 4 is used. Rather, it might be used with a title company form of deed of trust or other deed of trust that does not include personal property. Alternatively, the content of this security agreement form could be integrated into a deed of trust to create a combined document. The discussion of the provisions of the form in this chapter would still apply.

PRACTICE TIP: When the security agreement is integrated into the deed of trust, it is good practice to include a reference to the security agreement in the title of the document, *e.g.,* "Deed of Trust, Security Agreement, and Fixture Filing."

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§7.7 2. Additional Security Agreements, Assignments, and Pledges

Regardless of whether a separate security agreement or a combined deed of trust/security agreement is used, there are situations in which some particular personal property raises special issues, and a separate, specialized form of security agreement might also be used. The following are some examples:

- **Intellectual property.** If the lender's collateral will include patents, trademarks, copyrights, or other intellectual property, a separate security agreement might be appropriate to address issues unique to such assets.
- **Contract or lease.** A separate security agreement (often titled "assignment") is often used to grant a security interest in the borrower's rights and interests under a contract with a third party. This situation most often arises in construction lending, when the third party may be a general contractor, architect, or the like, but it may also arise in other loans. A separate assignment may be used for each contract, and each third party asked to consent to the assignment and agree to terms that protect the lender, such as those described in §7.45. (See §§9.26 and 9.27 for sample forms of assignment and consent documents for construction contracts and architectural contracts.) This type of assignment might also be used when the borrower leases, rather than owns, significant personal property necessary for operation of the real property.
- **Bank account.** A separate security agreement (sometimes called a "pledge") is often used for a significant deposit or escrow account, such as a reserve account, to deal with issues such as how the account will be funded, disbursed, and replenished. Even if there is not a separate security agreement, there will likely be a "control agreement," which serves to perfect the lender's security interest in the account. See §§7.29, 7.80. If the pledged account is to be used for receiving rent remittances directly from tenants (often referred to as a "lockbox" account; see §§1.45, 1.98), there will likely be a "lockbox agreement" that addresses the practicalities of the arrangement. The lockbox agreement may include the functions of the pledge and control agreements.
- **Unrelated collateral.** If the lender is taking a security interest in collateral that has no relation to the real property (sometimes called "nonproject collateral"), typically to provide additional credit support, sometimes a separate security agreement is used for that collateral.

These specialized (and often highly customized) security agreements are beyond the scope of this book. Note, however, that no matter what a document may be called—"security agreement," "assignment," "pledge," or otherwise—if its intent is to create a security interest in personal property, tangible or intangible, it is subject to Division 9 and the rules discussed in this chapter. See Com C §9109(a)(1). For additional information on security agreements, see Secured Transactions in California Commercial Law Practice, chap 2 (2d ed Cal CEB 2001); Intellectual Property in Business Transactions, chap 9 (Cal CEB 2008).

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B. Provisions Required for Validity of Security Agreement

§7.8 1. Granting Language

Revised Division 9, like prior law, defines "security agreement" as an agreement that "creates or provides for a security interest" (Com C §9102(a)(73); former Com C §9105(1)(*l*)). Courts interpreted that language in prior law to mean that a security agreement must ordinarily contain language explicitly granting (or, at the least, expressly providing for) the interest. See Secured Transactions in California Commercial Law Practice, chap 2 (2d ed Cal CEB 2001). The same should be true under the revised law. This result can easily be achieved by including the phrase, "Debtor hereby GRANTS to Secured Party a security interest in…." See §7.48.

DRAFTING CONSIDERATIONS: In a real property deed of trust, the grant of *real* property collateral runs from the borrower (trustor) to the trustee, for the benefit of the lender (beneficiary); the grant does not run directly from the borrower to the lender. When the security agreement is integrated into the deed of trust, the grant of *personal* property collateral should be stated separately from the grant of real property collateral and should take the form of the phrase quoted above, *i.e.,* running from the borrower to the lender, not to the trustee. See, ***e.g.,*** §4.64.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/ 2. Collateral Description; Coverage of Security Agreement/§7.9 a. Legal Requirements

2. Collateral Description; Coverage of Security Agreement

§7.9 a. Legal Requirements

A security agreement must contain a description of the collateral. Com C §9203(b)(3)(A). A description "is sufficient, whether or not it is specific, if it reasonably identifies what is described." Com C §9108(a). Commercial Code §9108(b) provides that a description "reasonably identifies" most types of collateral if it identifies the collateral by any of the following:

- Specific listing;
- Category;
- Commercial Code type (except for commercial tort claims, which must be identified specifically) (Com C §9108(e)) (for the various Commercial Code collateral types, see §§7.24-7.30);
- Quantity;
- Computational or allocational formula or procedure; or
- Any other method, if the identity of the collateral is objectively determinable.

There is an important caveat, however: Descriptions such as "all the debtor's assets" or "all the debtor's personal property" do *not* reasonably identify the collateral in a security agreement. Com C §9108(c). On the different rule for financing statements, see §7.33. (Additional limitations also apply to consumer transactions, which are beyond the scope of this book. See Com C §9108(e)(2), (f).)

Standard practice has long been to combine references to broad types of collateral (*e.g.,* "goods") with more specific, nonexclusive examples of covered collateral within those types (*e.g.,* "including appliances, furniture, furnishings," etc.). That practice is not required by the revised statute, however, which makes clear that description by Commercial Code type is sufficient for most collateral. Com C §9108(b)(3). Some counsel will likely continue to follow previous practice, while others will use abbreviated descriptions by type. See Alternatives 1 and 2, respectively, in §7.49.

A security interest can validly extend to most after-acquired collateral (*i.e.,* collateral not presently owned by the debtor but acquired after the grant of the security interest) if the security agreement so provides. Com C §9204(a). The collateral description should expressly so state, by referring to "the following collateral, now owned or hereafter acquired…." See §7.48.

Unless otherwise agreed, a security interest automatically attaches to identifiable proceeds of collateral. Com C §9315(a)(2). Even so, it is virtually universal practice to specifically mention "proceeds" in the collateral description. See §7.50. "Proceeds" is broadly defined by Com C §9102(a)(64) to mean

- whatever is acquired on the sale, lease, license, exchange, collection, or other disposition of collateral;
- whatever is collected on, or distributed on account of, collateral;
- rights arising out of collateral;
- to the extent of the value of the collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; and
- to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

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§7.10 b. Real Property Rents Excluded From Division 9

Commercial Code Division 9 generally applies to any transaction that creates a contractual security interest in personal property or fixtures. Com C §9109(a)(1). This general rule is subject to Com C §9109(c)-(d)'s exclusion of certain transactions from Division 9. Among the exclusions is "the creation or transfer of an interest in or lien on real property, including a lease or rents thereunder." Com C §9109(d)(11). Thus, even if a security agreement's broad collateral description might be read to include real property rents, the lender *must* create and perfect an interest in those rents by means of recorded real property documentation—the deed of trust (see chap 4) and the assignment of leases and rents (see chap 5). By contrast, a security agreement can be used to create a Division 9 security interest in leases or rents of personal property, or other income of a borrower (such as revenues of most operating businesses) that is not considered to be real property rents or their equivalent.

This distinction between real property rents and personal property income can be significant in the enforcement context, particularly in bankruptcy. See 11 USC §552; California Mortgages, Deeds of Trust, and Foreclosure Litigation §§11.56-11.59 (4th ed Cal CEB 2009); Secured Transactions in California Commercial Law Practice, chap 6 (2d ed Cal CEB 2001).

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§7.11 c. Practical Considerations

The real property lender's concern in drafting a collateral description is to make sure that the security agreement includes every type and item of personal property owned (or to be owned) by the borrower that is necessary or beneficial for the use, operation, or ownership of the real property. Failure to include all such personal property could seriously affect the lender's ability to realize the full value of the real property should foreclosure occur. The lender or other foreclosure-sale purchaser would not acquire the omitted personal property through the foreclosure and would be forced to incur the potentially considerable expense of replacing it.

PRACTICE TIP: Lender's counsel should approach the task of identifying personal property to be included in the loan transaction much the same as buyer's counsel would do in a purchase transaction. A buyer is what the lender someday may become if the borrower defaults and foreclosure results.

The significance of this issue for the lender depends on the type of real property involved. In hotel financing, for example, sweeping coverage of personal property is crucial. Operation of the real property for its improved use as a hotel—and thus the value of the property as a going concern—depends on the presence of everything from beds to televisions to switchboards to kitchen equipment to restaurant furniture and more. (Some of this personal property might be leased by the borrower, in which case the lender's security interest must cover the borrower's interest under the lease, and the lender needs special protections from the lessor. See §7.45.)

Personal property collateral is less significant when the real property is for lease to tenants, as with leased office, retail, industrial, or unfurnished apartment properties. In these situations, most of the tangible personal property inside the improvements belongs to the tenants, not the borrower. Even in this context, however, there are likely to be items of personal property with important economic and practical significance to a foreclosing lender. Tangible personal property owned by the borrower typically includes common area furnishings and maintenance and other building-services equipment. Intangible property may also exist (which may be true even in loans on unimproved land). For example, a trade name for the property may have important value, *e.g.,* the name of an apartment or office building. In addition, any contracts between the debtor and third parties may be valuable, as well as any plans, specifications, drawings, studies, maps, and the like.

The form security agreement set out in §§7.46-7.77 includes a wide-ranging description of collateral, typical of institutional lenders' forms. See §§7.49-7.50. In most transactions, the borrower would be hard-pressed to complain that such a description is too broad, because it legitimately attempts to encompass the complete economic unit made up of the real property and all associated personal property. This is especially true if the borrower is a single-project entity owning no other properties. When the borrower does own properties other than the one presently being financed, it is important for borrower's counsel to ensure that the description does not sweep in personal property associated with the other properties. Doing so could interfere with the borrower's ability to sell or borrow against them.

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§7.12 3. Authentication by Debtor

The security agreement must be authenticated by the debtor. Com C §9203(b)(3)(A). See §7.4. In a real estate secured loan, authentication is commonly achieved through a written signature on a combined deed of trust/security agreement or on a separate security agreement. Care should be taken that the agreement and all other loan documents correctly name the debtor and that the name corresponds to the name shown in the financing statement. See §§7.20, 7.32.

A security agreement does not require a signature or other authentication by the secured party.

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§7.13 C. Identification of Secured Obligation

A security interest does not exist in a vacuum; rather, by definition, it is an interest in personal property that secures payment or performance of an *obligation*. Com C §1201(b)(35). The statute nowhere requires that the secured obligation be explicitly identified in the security agreement, and, at least in some circumstances, a security agreement omitting that information may be enforceable. Compare *New W. Fruit Corp. v Coastal Berry Corp.* (1991) 1 CA4th 92, 98, 1 CR2d 664 (relying on parole evidence), with *Needle v Lasco Indus.* (1970) 10 CA3d 1105, 1108, 89 CR 593 (stating as a general rule that a security agreement must specify the obligation secured). Prudent practice, however, dictates that a security agreement make very clear the obligations it secures.

Whether the security agreement is a separate document or is integrated into the deed of trust, the obligations secured by the personal property and the real property should ordinarily be identical. Typically, secured obligations are defined to include all of the borrower's obligations under all of the loan documents, *e.g.,* the note, deed of trust, security agreement, *etc.* (although perhaps not obligations under a separate environmental indemnity agreement; see §1.70 and chap 5A). See §7.52.

Older forms of deeds of trust and security agreements often had "dragnet" clauses, which included not only the present loan within the secured obligations, but all other and future obligations of the borrower to the lender. Commercial Code §9204(c) provides that a "security agreement may provide that collateral secures… future advances or other value, whether or not the advances or value are given pursuant to commitment." In view of the many consequences of taking real property collateral for an obligation, however, such blanket dragnet clauses are now rare in real estate loan transactions. See California Mortgages, Deeds of Trust, and Foreclosure Litigation §§9.59-9.73 (4th ed Cal CEB 2009).

A far more limited clause, typically found in title company deeds of trust, states that the security is given for the present loan, and for future loans only if the future loan documents expressly so state. Such a provision is not objectionable and leaves for the future the decision of whether to link present and later transactions. See paragraph 2.2 in §7.52.

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§7.14 D. Protective Covenants

A security agreement need contain only the three statutorily required items discussed above—the grant, a description of collateral, and the debtor's authentication (see §§7.8-7.12)—normally coupled with identification of the obligation secured (see §7.13). It is nearly universal practice, however, to include fairly extensive covenants, representations, and warranties of the borrower that focus on protecting the collateral and the lender's security interest in it. These protective provisions typically cover the following:

- The status of title of the collateral (see paragraph 3.2.1 in §7.54);
- Maintaining the collateral in good condition and repair (see paragraph 3.2.2 in §7.54);
- Replacing damaged, lost, or worn-out collateral (see paragraph 3.2.3 in §7.54);
- Complying with laws relating to the collateral (see paragraph 3.2.5 in §7.54);
- Protecting the collateral against liens (see paragraph 3.2.6 in §7.54, and §7.56);
- The lender's rights to inspect the collateral (see §7.55);
- Prohibiting further encumbrances on the collateral (see paragraph 3.2.1 in §7.54, and §7.56);
- Paying taxes on the collateral (see §7.56);
- Insuring the collateral (see §7.57);
- Agreements with third parties, such as contracts or leases, that are part of the collateral (see §7.60); and
- Litigation and indemnity in connection with the collateral (see §§7.58, 7.63).

In the form security agreement in this chapter, section 3 (see §§7.53-7.63) includes representative protective provisions on these and other topics. These provisions are often the subject of at least some negotiation, with the lender seeking maximum protection and the borrower seeking maximum flexibility. The appropriate balance between these objectives varies in individual transactions, depending on the nature of the real and personal property, the borrower's business, the lender's customary lending practices and policies, and the relationship between borrower and lender.

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§7.15 E. Events-of-Default Provisions

Identifying events of default is particularly important to both lender and borrower because such events trigger the lender's right to enforce its remedies. Com C §9601(a). The events of default (including any cure rights) specified in the security agreement should be consistent with those specified in the note, deed of trust, and other loan documents. Careful attention must be paid to this issue, particularly when a separate security agreement is used. All documents should be "cross-defaulted"; a default in one should be a default in all. See paragraph 4.1.4 in §7.64.

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F. Remedies Provisions

1. Legal Considerations

§7.16 a. Personal Property Remedies

Commercial Code §§9601-9629 detail the rights and remedies available to a secured party after a default occurs in the secured obligations, subject to certain protections for the borrower. The remedies include collection rights against account debtors (Com C §9607), rights to take possession of collateral (Com C §9609), and rights to dispose of collateral by public or private sale, lease, license, or other method of disposition (Com C §§9610-9616). Borrower protections include duties of commercial reasonableness imposed on the lender. Com C §§9607(c), 9608(a)(3), 9610(a)-(b), 9611(e)(1), 9615(c), 9626(b)(2)(C), 9627. Commercial Code §9610(b) provides, for example, that "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable." Commercial Code §9627 provides guidance for determining commercial reasonableness. For discussion of these rights, remedies, and protections, see Secured Transactions in California Commercial Law Practice, chap 5 (2d ed Cal CEB 2001).

Commercial Code §9601(a) provides that on default the secured party has all of the statutorily prescribed rights and remedies (*i.e.,* whether or not they are set out in the security agreement), as well as other rights and remedies that the security agreement may provide. The parties' ability to contractually alter the statutory scheme is limited somewhat by Com C §9602, which refers to several of the statutory borrower-protective provisions and invalidates attempts to waive or vary them. The parties may, however, "determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party under a rule stated in Section 9602 if the standards are not manifestly unreasonable." Com C §9603.

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§7.17 b. Mixed Collateral Remedies

The remedial provisions of Commercial Code Division 9 emphasize procedural flexibility, tempered by the overarching duty of commercial reasonableness, and impose few limitations on the lender's ability to obtain deficiency judgments. This approach is thus quite different from California's foreclosure remedies for real property, which are procedurally rigid and impose significant and substantive limitations on deficiencies. See CC §2924; CCP §§580a-580b, 580d, 726.

When a loan is secured by both personal and real property, these two very different approaches can conflict. Commercial Code §9604, a nonuniform California provision, reflects an attempt to reconcile them, with the goal of preserving the lender's flexibility for personal property without undermining the strict rules for real property. The provision authorizes the lender to proceed separately as to personal property collateral under the Commercial Code and real property under real property law, or to proceed against personal and real property together under real property law, at the lender's election. See, *e.g., Kearns v Transamerica Home Loan (In re Kearns)* (BAP 9th Cir 2004) 314 BR 819, aff'd (9th Cir 2006) 201 Fed Appx 473 (unpublished opinion). For a detailed discussion of §9604 (which is essentially the same as former Com C §9501(4)), see Secured Transactions in California Commercial Law Practice, chap 5 (2d ed Cal CEB 2001); California Mortgages, Deeds of Trust, and Foreclosure Litigation §§9.12-9.23 (4th ed Cal CEB 2009).

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§7.18 2. Negotiating and Drafting Considerations

Although, as noted in §7.16, the remedial provisions of Commercial Code Division 9 apply automatically to security interests in personal property, the nearly universal practice is to spell out at least the principal remedies in the security agreement. Although this step is not legally required, it alerts the borrower to the scope of potential remedies. There is usually little in such contractual provisions that is objectionable to the borrower, to the extent that the provisions track and reasonably implement the statutory remedies. The borrower should object if the contractual language attempts to curtail the borrower's rights or lender's duties itemized in Com C §9602.

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§7.19 G. Miscellaneous Provisions

The miscellaneous general provisions in the security agreement (see §§7.67-7.73), covering such topics as notice, governing law, and the like, should be consistent with those in the other loan documents.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.20 H. Borrower Information Provisions

§7.20 H. Borrower Information Provisions

The form security agreement includes a section (see §7.74) in which the borrower is asked to represent and warrant to the secured party the accuracy of information about the borrower that will be required in the financing statement and that will determine the proper place of filing the financing statement. This helps to focus attention on getting the correct information, but if the information is inaccurate and the lender files incorrectly, the representations and warranties will be of no help to the lender in a priority contest with a competing creditor or bankruptcy trustee. Due diligence by the lender or its counsel is therefore essential. See §§7.32, 7.34.

On postclosing changes in the borrower's name or location, see §§7.32, 7.34.

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III. PERFECTION OF SECURITY INTEREST; THE FINANCING STATEMENT

A. General Principles

§7.21 1. Attachment and Perfection

A security interest in personal property "attaches" to collateral when it becomes enforceable against the debtor with respect to that collateral. Com C §9203(a). Under Com C §9203(b), this "attachment" is accomplished when the following occur:

- Value has been given (*e.g.,* the loan has been made or the secured creditor has made a commitment to make a loan);
- The debtor has either rights in the collateral or the power to transfer rights in the collateral to a secured party; and
- For most transactions, the debtor has authenticated a security agreement containing the required provisions discussed in §§7.8-7.12.

Even after a security interest has attached to collateral and become enforceable against the debtor, it remains vulnerable to most competing claims against the same collateral unless it is perfected. "Perfection" refers to the process by which third parties are, by a method prescribed by the Commercial Code, ordinarily put on notice that a security interest does or may exist—*e.g.,* by filing a financing statement. A security interest is perfected when it has attached and all applicable requirements for perfection have been satisfied. Com C §9308(a).

Perfection of a security interest is crucial. Usually an unperfected security interest will lose out to competing lien creditors, secured creditors, buyers, or other transferees. See Com C §§9317, 9320-9322. An unperfected security interest may also be set aside if the borrower files for bankruptcy. 11 USC §544(a). See Secured Transactions in California Commercial Law Practice, chap 6 (2d ed Cal CEB 2001).

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§7.22 2. Methods of Perfection

Division 9 provides three primary methods for perfection of a security interest:

- **Perfection by filing.** For many types of collateral, security interests are perfected by filing a financing statement. Com C §9310(a). A financing statement is a simple form, usually filed with a state office (in California and many states, the office of the Secretary of State), giving notice of an actual or potential security interest in favor of the named secured party. See Com C §§9501-9528. Under revised Article 9, the financing statement is typically filed in the state where the debtor is "located," even if the collateral is located elsewhere. See Com C §§9301(1), 9307, 9501. The financing statement's contents and filing are discussed in §§7.31-7.36. On when perfection by filing is appropriate or required, see §§7.23-7.27.
- **Possession perfection.** Security interests in some types of collateral can or must be perfected by the secured party (or its agent) taking physical possession of the collateral. Com C §9313. See §7.30.
- **Control perfection.** Security interests in other types of collateral can or must be perfected by the secured party having "control" of the collateral. Com C §9314. Division 9 specifies the manner of obtaining control for different types of collateral. Com C §§9104-9107. See §§7.29-7.30.

As discussed in §§7.23-7.30, the choice among these methods of perfection depends on the type of collateral involved, and, if more than one method is permitted for a particular type of collateral, the practicalities of the available methods and the degree of protection provided by each.

NOTE: In addition to these affirmative methods of perfection, in some circumstances perfection may occur automatically. Com C §§9310(b)(1) and 9308(d)-(g) (perfection in certain types of collateral automatically perfects in other collateral); 9310(b)(2) and 9309 (when security interest is perfected automatically on attachment); 9310(b)(5) and 9312(e)-(g) (temporary automatic perfection in certificated securities, negotiable documents, instruments); 9310(b)(9) and 9315(c)-(d) (automatic perfection in proceeds). See also Com C §9109 (excluding certain transactions from the scope of Commercial Code Division 9 altogether).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/ B. Collateral Types and Perfection Methods/§7.23 1. Perfection by Filing

B. Collateral Types and Perfection Methods

§7.23 1. Perfection by Filing

Three collateral types identified by the Commercial Code— "goods," "accounts," and "general intangibles"—compose a large percentage of the personal property likely to be included in a real property secured loan transaction. See §§7.24-7.26. Filing a financing statement is generally the appropriate or required method of perfecting a security interest in each of them. Because most real property secured loans that include personal property collateral involve at least one of these three collateral types, it is safe to say that a financing statement should be filed in virtually every mixed collateral loan transaction.

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§7.24 a. Goods

Division 9 defines "goods" to mean "all things that are movable when a security interest attaches." Com C §9102(a)(44). The term includes the following:

- Fixtures;
- Standing timber to be cut and removed under a conveyance or contract for sale;
- The unborn young of animals;
- Crops grown, growing, or to be grown;
- Manufactured homes; and
- Computer programs embedded in goods and any supporting information provided in connection with a transaction relating to the program if (a) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (b) by becoming the owner of the goods, the person acquires a right to use the program in connection with the goods.

Goods are further subcategorized into three specifically defined types—"consumer goods" (Com C §9102(a)(23)), "farm products" (Com C §9102(a)(34)), and "inventory" (Com C §9102(a)(48))—and a residual fourth type, "equipment" (Com C §9102(a)(33)).

The term "goods" does not include the following (Com C §9102(a)(44)):

- A computer program embedded in goods that consist solely of the medium with which the program is embedded; or
- Accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, instruments, investment property, letter-of-credit rights, letters of credit, money, or oil, gas, or other minerals before extraction.

A security interest in goods can ordinarily be perfected by filing or by the secured party's taking possession of the goods. Com C §§9310(a), 9310(b)(6), 9313(a). In most real property secured transactions, however, the goods are vital to the functioning of the real property, so perfection by possession is impractical.

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§7.25 b. Accounts

Commercial Code §9102(a)(2) defines "account" to mean a right to payment of a monetary obligation, whether or not earned by performance,

- for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of;
- for services rendered or to be rendered;
- for an insurance policy issued or to be issued;
- for a secondary obligation incurred or to be incurred;
- for energy provided or to be provided;
- for the use or hire of a vessel under a charter or other contract;
- arising from use of a credit or charge card or information contained on or for use with the card; or
- as winnings in a lottery or other game of chance operated or sponsored by a state or governmental unit of a state, or person licensed or authorized to operate the game by a state or governmental unit of a state.

The term also includes health care insurance receivables. Com C §9102(a)(2). See Com C §9102(a)(46).

The term "accounts" does *not* include the following (Com C §9102(a)(2)):

- Rights to payment evidenced by chattel paper or an instrument;
- Commercial tort claims;
- Deposit accounts;
- Investment property;
- Letter-of-credit rights or letters of credit; or
- Rights to payment for money or funds advanced or sold, other than rights arising from the use of a credit or charge card or information contained on or for use with the card.

A security interest in accounts can be perfected only by filing a financing statement. See Com C §9310(a).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.26 c. General Intangibles

§7.26 c. General Intangibles

"General intangibles" is a residual category that includes any personal property (including things in action) *other than* "accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas or other minerals before extraction," and the term includes payment intangibles and software. Com C §9102(a)(42).

A security interest in general intangibles can be perfected only by filing a financing statement. See Com C §9310(a).

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§7.27 d. Other Collateral Types

Filing a financing statement is also a permissible means of perfecting a security interest in these additional types of collateral (Com C §9312(a)):

- **Chattel paper** (a record or records evidencing both a monetary obligation and a security interest in or lease of specific goods; Com C §9102(a)(11));
- **Negotiable documents** (documents of title such as warehouse receipts or bills of lading; Com C §§9102(a)(30), 1201(b)(16), 7102(1)(e));
- **Instruments** (negotiable instruments or other writings that evidence a right to the payment of a monetary obligation, not itself a security agreement or lease, of a type that in ordinary course of business is transferred by delivery with any necessary endorsement or assignment; Com C §9102(a)(47)); and
- **Investment property** (a security, certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account; Com C §9102(a)(49)).

Although filing is permissible for these collateral types, it is not optimal, because possession perfection or control perfection ordinarily will confer broader priority rights. See Com C §§9328, 9330.

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§7.28 2. Perfection Other Than by Filing

Filing a financing statement does not perfect a security interest in all types of collateral. The following additional types of collateral may be involved in a real estate secured loan transaction, and may require means of perfection other than filing.

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§7.29 a. Deposit Accounts

Not infrequently, real property secured loans include a security interest in a deposit of money. For example, a loan transaction might include a reserve account, tax and insurance account, capital improvements account, or the like, and in the case of income-producing property, might include an account into which rents are remitted directly by the tenants (usually referred to as a "lockbox" account; see §§1.45, 1.98). Whatever the purpose of the account, it will likely take the form of a "deposit account" within Com C Division 9, necessitating special steps to perfect the lender's security interest.

Division 9 defines "deposit account" as a "demand, time, savings, passbook, or similar account maintained with a bank," not including "investment property or accounts evidenced by an instrument." Com C §9102(a)(29). (A "bank" is an organization "engaged in the business of banking," including savings banks, savings and loan associations, credit unions and trust companies. Com C §9102(a)(8).) A "deposit account" is not included in the definition of "account." Com C §9102(a)(2). Thus, the perfection-by-filing rule applicable to accounts (see §7.25) does not apply to deposit accounts.

The secured party perfects a security interest in a deposit account by having control of it (Com C §9314(a)-(b)), and this is the only permissible means of perfection (Com C §9312(b)(1)) except to the extent that amounts on deposit are identifiable proceeds of other collateral in which the secured party had a perfected security interest (Com C §9315(a)(2), (b)(2), (c), (d)(2)). Under Com C §9104(a), a secured party has control of a deposit account if any one of three conditions is satisfied:

- The secured party is the bank holding the deposit;
- "The debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor" (see §7.80 for an attorney-drafted form of control agreement for a deposit account, with a discussion of forms of control agreements prepared by committees of the Business Law Sections of both the American Bar Association and the California State Bar, and a discussion of potential difficulties that may arise in obtaining a bank's consent to a control agreement); or
- The secured party itself "becomes the bank's customer with respect to the deposit account."

Control by one of these means is not defeated by the debtor's retaining the right to direct the disposition of funds from the deposit account. Com C §9104(b). Perfection continues only for as long as the secured party has control. Com C §9314(c)(1).

Commercial Code §9304(a) provides that the local law of a bank's jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in a deposit account maintained with that bank. Commercial Code §9304(b) provides rules for determining the bank's jurisdiction. For practice tips on obtaining a bank's consent to a form of a deposit account control agreement, see §7.80.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.30 b. Other Collateral Types

§7.30 b. Other Collateral Types

Under the Commercial Code, a security interested in the following additional collateral must be perfected by means other than filing a financing statement:

- **Letter-of-credit rights** (*i.e.,* rights to payment and performance under a letter of credit; Com C §9102(a)(51)). Control perfection is normally required. Com C §§9312(b)(2). For the method of control, see Com C §9107. Perfection occurs automatically, however, when the letter-of-credit rights are "supporting obligations" (Com C §9102(a)(77)) with respect to payment or performance under an account, chattel paper, document, general intangible, instrument, or investment property on which the security interest is perfected (Com C §9308(d)).
- **Money** (*i.e.,* a medium of exchange authorized or adopted by a government; Com C §1201(b)(24)). Possession perfection is required. Com C §9312(b)(3).
- **Insurance policies,** and claims in or under insurance policies, including unearned premiums, but not including health care insurance receivables. Perfection by written notice to the insurer is required. Com C §9312(b)(4). (This is a nonuniform provision of California law. The UCC excludes from its coverage the transfer of interests in or assignment of claims under a policy of insurance, other than the assignment by or to a health care provider of a health care insurance receivable. UCC §9-109(d)(8) (not adopted in California).)

In addition, the perfection of a security interest in some types of collateral is not governed by the Commercial Code, and compliance with other statutes, state or federal, is required. This includes the following:

- **Vehicles and boats,** for which registration is required under the Vehicle Code (Com C §9311(a)(2)(A));
- **Mobilehomes and commercial coaches,** for which registration is required under the Health and Safety Code (Com C §9311(a)(2)(B));
- **Approved air contaminant emission reductions,** for which registration is required under the Health and Safety Code (Com C §9311(a)(2)(C)); and
- **Documented vessels and aircraft,** for which federal registration systems preempt state law (see Com C §9311(a)(1)).

There is at present some uncertainty regarding the proper method for perfecting a security interest in intellectual property such as patents, trademarks, and copyrights—whether federal registration, state filing, or both. There are also significant practical problems in perfecting security interests in such property when federal registration is required or is advisable. See Intellectual Property in Business Transactions, chap 9 (Cal CEB 2008); Secured Transactions in California Commercial Law Practice, chap 3 (2d ed Cal CEB 2001). In *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, cert denied 122 S Ct 1069 (2002), the Ninth Circuit held that neither the Patent Act (35 USC §§261-262) nor the UCC requires federal registration of a security interest in a patent. The court did not address, however, whether federal registration is necessary to protect against good faith purchasers of an ownership interest in the patent. With respect to copyrights, in dicta the court in *Cybernetics* noted that federal registration likely *is* required to perfect a security interest. In *Aerocon Eng'g v Silicon Valley Bank* (*In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120, however, the Ninth Circuit distinguished between registered and unregistered copyrights and held that security interests in the latter are perfected by a state-law UCC filing. 303 F3d at 1131. In that situation, the creditor should be alert to the possibility that subsequent registration of the copyright might result in loss of perfection of the security interest. For an excellent discussion of the many legal and practical problems in perfecting security interests in intellectual property collateral, see Working Capital Financing in the New Economy, a report by the UCC Committee of the State Bar's Business Law Section, available through the State Bar's website listed in the Directory.

As noted in §7.27, there are also some types of collateral (chattel paper, negotiable documents, instruments and investment property) for which filing a financing statement is a permissible, but not optimal, means of perfection. Possession perfection or control perfection should be considered. See Com C §§9105-9106, 9313-9314.

PRACTICE TIP: A lender taking personal property collateral in a real property loan transaction almost invariably files a financing statement to perfect its security interest. Whether additional steps are necessary to perfect depends on the types of collateral involved and requires careful analysis. As a practical matter, the collateral description in a real property secured loan transaction often includes types of collateral that require some special method of perfection, but if there is no important collateral known to be within those types, the lender may decide to do no more than file a financing statement.

For a detailed discussion of perfection issues and methods for various types of collateral, see Secured Transactions in California Commercial Law Practice, chap 3 (2d ed Cal CEB 2001). On fixtures, see §§7.38-7.41A.

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C. Financing Statements

§7.31 1. Required Contents

Division 9 requires that the following nine items of information be included in a financing statement to be filed in California (the last three only if the debtor is an organization rather than an individual):

(1) The name of the debtor (see §7.32) (Com C §§9502(a)(1), 9516(b)(3)(A));

(2) The name of the secured party or a representative of the secured party (Com C §§9502(a)(2), 9516(b)(4));

(3) An indication of the collateral covered by the financing statement (see §7.33) (Com C §9502(a)(3));

(4) A mailing address for the secured party of record (Com C §9516(b)(4));

(5) A mailing address for the debtor (Com C §9516(b)(5)(A));

(6) An indication of whether the debtor is an individual or an organization (Com C §9516(b)(5)(B));

(7) If the debtor is an organization, the type of organization (Com C §9516(b)(5)(C)(i));

(8) If the debtor is an organization, the jurisdiction of organization (Com C §9516(b)(5)(C)(ii)); and

(9) If the debtor is an organization, the organizational identification number or a statement that the debtor has none (Com C §9516(b)(5)(C)(iii)).

Additional requirements apply to a financing statement filed as a fixture filing. Fixture filings are discussed in §§7.38-7.41A.

The consequences of omitting some of this information vary, in somewhat complicated fashion. If a financing statement lacks any of items (1) through (3) it is not "sufficient" (Com C §9502(a)), even if the filing office accepts it for filing. The filing office is both authorized and instructed to refuse to accept a financing statement for filing if it lacks any of items (1) (if the filing office is unable to index the financing statement), (2), or (4)-(9) (Com C §§9516(b), 9520(a)). If the filing office mistakenly accepts a financing statement that omits any of items (4)-(9), but the financing statement does contain items (1)-(3), the financing statement is effective, but incorrect information on items (5)-(9) may impair the priority of the security interest. Com C §§9520(c), 9338. On a filing office's improper rejection of a financing statement, see Com C §9516(d).

In a significant departure from prior law, revised Division 9 does *not* require the debtor's signature or other authentication on the financing statement. Instead, it provides that a financing statement may be filed if the debtor authorizes the filing in an authenticated record. Com C §9509(a)(1). By statute, the debtor's authentication of a security agreement also authorizes the filing of a financing statement covering the collateral described in the security agreement. Com C §9509(b). (This change in the law was intended to facilitate paperless filings; see UCC §9-502 Official Comment 3.)

Although the law requires no particular form of financing statement, it does set out a uniform form of financing statement (Form UCC1), which the filing office may not refuse to accept. Com C §9521(a). Use of this form, which contains blanks for all required information, is advisable and is common practice. The statutory form of UCC1 financing statement is reprinted in §7.78 and a sample collateral description addendum to the financing statement, corresponding to the sample form of security agreement, is in §7.79. All of the official UCC forms are available on the website of the California Secretary of State, listed in the Directory.

A financing statement must also be accompanied by a filing fee. Com C §9516(b)(2). Government Code §12194 (see also Com C §9525) establishes the fee, the amount of which depends on whether the financing statement "record" (see §7.4) is in writing and, if so, its length:

- If the record is in writing, $10 if one or two pages in length and $20 if longer;
- If the record is in another medium (*e.g.,* electronic) and the Secretary of State has authorized filings in that medium, $5.

A financing statement contains no information on the details of the loan. In fact, a financing statement may be filed

even before a security agreement is entered into or a security interest attaches (Com C §9502(d)), if the debtor authorizes the filing in an authenticated record. Com C §9509(a)(1). (The benefit of doing so is that priority often dates from the time of filing, even if that predates making the loan and the granting the security interest. See Com C §9322(a)(1), and discussion in §7.44.) The financing statement merely gives notice to third parties that the named secured party *may* have a security interest in the described collateral. The burden is on the third party to inquire further.

Two of the required items on a financing statement—the debtor's name and the collateral description—are particularly important and are discussed in §§7.32-7.33. An extended discussion of financing statement issues is in Secured Transactions in California Commercial Law Practice, chap 3 (2d ed Cal CEB 2001).

PRACTICE TIP: In many transactions involving California real property and associated personal property, it is necessary to file the financing statement in a state other than California. See §7.34. The rules for financing statements discussed in this section and in §§7.32-7.33 apply when the filing is to be made in California. If the filing is to be made in another state, Article 9 as adopted in that state must be consulted because there are some state-to-state differences.

NOTE: As discussed in §7.37, a filed financing statement is normally effective for 5 years. Com C §9515(a). Special longer-duration rules apply to financing statements filed in connection with public financing transactions (defined in Com C §9102(a)(67)), manufactured home transactions (Com C §9102(a)(54)), and transactions in which the debtor is a transmitting utility (Com C §9102(a)(80)), but only if the financing statement so indicates. Com C §9515(b), (f). When applicable, this information should be shown by a checkmark in one of the boxes in Item #18 of the financing statement addendum form (UCC1Ad) found in Com C §9521(a), and that form should be attached to and filed as part of the UCC1 financing statement.

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§7.32 a. Name of Debtor

The official records of financing statement filings are maintained and searched by the debtor's name. It is thus crucial that the financing statement use the debtor's full, correct, and legal name, correctly spelled (Item 1 on the UCC-1 financing statement form, see §7.78). Failure to do so may cause the financing statement to be ineffective in giving notice of the security interest, defeating perfection and priority.

Commercial Code §9503(a) states that a financing statement sufficiently provides the name of the debtor *only* if it complies with these rules:

- If the debtor is a "registered organization" (see Com C §9102(a)(70)), the financing statement must show the name of the debtor indicated on the public record of the debtor's jurisdiction of organization which shows the debtor to have been organized;
- If the debtor is a decedent's estate, the financing statement must show the name of the decedent and state that the debtor is an estate;
- If the debtor is a trust or a trustee acting with respect to trust property, the financing statement must show (1) the name specified for the trust in the organic documents or, if no name is specified, show the name of the settlor and additional information to distinguish the trust from others having the same settlor (Com C §9503(a)(3)(A)), and (2) that the debtor is a trust or trustee acting with respect to property held in trust (Com C §9503(a)(3)(B)).

NOTE: In California, the general rule is that legal ownership of trust assets is vested in the trustee. See *Reagh v Kelley* (1970) 10 CA3d 1082, 1097, 89 CR 425; *Crystal Pier Co. v Schneider* (1919) 40 CA 379, 381, 180 P 948; see also Prob C §15200. Thus, when trust assets are the subject of a security interest and the trust is governed by California law, the trustee is the "debtor" for purposes of Division 9. See Com C §9102(a)(28).

PRACTICE TIP: Even though the trustee is the debtor, the *name* to be shown on the financing statement is not the trustee's name, but the trust's name (or if it has none, then the settlor's name and information to distinguish the trust from others with the same settlor). Com C §9503(a)(3)(A). This special name rule does not change the effect of the trustee's being the debtor. For example, the trustee's location will control the place of filing under Com C §9301, and where the financing statement requires the debtor's address and other identifying information, in Items 1c-1g of the official form, the trustee's address and information will be shown. Under Com C §9503(a)(3)(B), the financing statement must also indicate that the debtor is a "trustee acting with respect to property held in trust." This may be accomplished by attaching the official UCC1Ad form of financing statement addendum found in Com C §9521(a) and checking the appropriate box in Item #17.

In cases not covered by the foregoing rules, if the debtor has a name, the financing statement must show the debtor's individual or organizational name, and if the debtor does not have a name, the financing statement must show the names of the partners, members, associates, or other persons who constitute the debtor.

A financing statement that complies with these rules need not show a trade name or other name of the debtor, or the names of partners, members, associates, or other persons constituting the debtor. Com C §9503(b). Filing only under a debtor's trade name is not sufficient. Com C §9503(c).

Commercial Code §9506 does allow some slight leeway if an error occurs. It states that a financing statement "substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading." But failure to comply with Com C §9503's rules is per se "seriously misleading" unless a search of the records under the debtor's correct name, using the filing office's standard search logic, would disclose the financing statement. Com C §9506(b)-(c). The California Secretary of State's search logic is set out in Uniform Commercial Code Administrative Rules available on the website listed in the Directory. There are differences in the search logic used by various states.

WARNING: Common, easily made errors—such as spelling mistakes, use of trade names for organizations and of

nicknames or other name variations for individuals—can defeat the effectiveness of a filed financing statement. See, *e.g., Corona Fruits & Veggies, Inc. v Frozsun Foods, Inc.* (2006) 143 CA4th 319, 48 CR3d 868 (debtor's full name was "Armando Munoz Juarez" but financing statement indicated "Armando Munoz," which was *the* name debtor went by); *Pankratz Implement Co. v Citizens Nat'l Bank* (Kan 2006) 130 P3d 57 (misspelled first name of individual debtor); *Clark v Deere & Co. (In re Kinderknecht)* (BAP 10th Cir 2004) 308 BR 71 (nickname). Getting the debtor's name right is essential to perfection of a security interest by filing.

PRACTICE TIP: Filing office indexing problems can arise from names that include foreign characters, diacritical marks, reverse order of surname and given name, or other non-standard elements. Counsel should research how best to proceed in the jurisdiction in which the documents will be filed.

The form security agreement in this chapter includes representations and warranties by the borrower as to the information required on the financing statement. See §7.74.

PRACTICE TIP: A careful lender's counsel will obtain documentation to establish the borrower's legal name when possible. This is easily done in the case of registered organizations, but is considerably more difficult in the case of individuals. Correctly ascertaining the debtor's name is also important to the lender in searching for previously filed financing statements. See §7.44.

The troublesome issue of determining the debtor's correct name has led some states to adopt nonuniform amendments to the relevant UCC provisions. See Neb Rev Stat (UCC) §9-506(b)(iii) (name of individual debtor shown on financing statement not "seriously misleading" if search under debtor's correct *last* name, using filing office's standard search logic, would disclose financing statement) (effective Sept. 2, 2010); Tenn C Ann §47-9-503 (allowing individual debtors to be identified by name on debtor's driver's license or state identification "license"); Tex Bus & Com C Ann §9.503 (allowing individual debtors to be identified by name on driver's license or state identification "certificate"). In addition, the Article 9 Review Committee of the UCC's Permanent Editorial Board is also considering recommending changes to UCC §9-503, which might provide a safe harbor if the name shown on a state-issued driver's license or identification card is used on the financing statement. The website for the Article 9 Review Committee can be found in the Directory. At present, though, in California and in most states, there is no safe harbor.

If a borrower changes its name postclosing, such that a filed financing statement becomes seriously misleading (see Com C §9506), the financing statement nonetheless remains effective to perfect a security interest in collateral acquired by the borrower before, or within 4 months after, the change, but is not effective to perfect a security interest in collateral acquired thereafter unless an amendment is filed within the 4-month period. Com C §9507(c). Regarding the effect of transfers of collateral to a new debtor, see Com C §§9316(a), 9507(a)-(b), 9508.

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§7.33 b. Description of Collateral

Under Com C §9504, a financing statement sufficiently indicates the collateral if it provides either of the following:

- A description of collateral under Com C §9108, discussed in §7.9, which is the same rule applicable to security agreements; or
- An indication that the financing statement covers all assets or all personal property.

The latter alternative departs significantly from prior law and from the rule applicable to security agreements. As noted in §7.9, Com C §9108(c) provides that descriptions such as "all the debtor's assets" or "all the debtor's personal property" do not reasonably identify the collateral, and thus are inadequate for use in security agreement. But Com C §9504(2) expressly validates the use of such descriptions (often referred to as "supergeneric" descriptions) in financing statements.

The most common practice has been to use the identical description of personal property collateral in both the security agreement and the financing statement, typically by attaching the description as an addendum to the financing statement form. See §7.79. Using different descriptions creates the risk that a security interest may be granted in certain collateral but not covered in the financing statement, or vice versa, resulting in loss of the security interest in that collateral. Inconsistent descriptions of collateral in the security agreement and the financing statement are present in a surprising number of transactions, simply through inadvertence.

With Com C §9504(2)'s validation of supergeneric descriptions, some lenders may adopt the practice of requesting such descriptions in the financing statement even if the security agreement does not, in fact, extend to all of the debtor's personal property. As long as the debtor authorizes the filing of such a financing statement (Com C §9509(a)(1); see §§7.31, 7.62), there is no reason this cannot be done. If the security interest does not extend to all of the borrower's personal property, however, the borrower should be cautious about authorizing supergeneric descriptions because of the potentially adverse impact on the borrower's ability to obtain financing from other lenders on other assets.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/ 2. Filing Initial Financing Statement/ a. Where to File/§7.34 (1) As Between Jurisdictions: General Rules

2. Filing Initial Financing Statement

a. Where to File

§7.34 (1) As Between Jurisdictions: General Rules

Under revised Division 9, financing statements for most types of collateral are to be filed in the state where the *debtor* is located. See Com C §§9301(1) (perfection and priority are normally governed by the "local law" of the jurisdiction where a debtor is located) and 9501 (where "local law" of state governs, filing is made in that state in the specified office). This requirement represents a significant departure from prior law, which required filing on most tangible property in the state where the *property* was located. See former Com C §9103(1)(b). Prior law required filing with respect to accounts and general intangibles in the state where the debtor was located (see former Com C §9103(a)), but, as noted below in this section, it used a significantly different approach to determine location. (On the rules governing the transition from prior to current law, see §7.42; on the proper place to file a financing statement filed as a fixture filing, see §§7.41-7.41A.)

Commercial Code §9307 states the rules for determining a debtor's location, of which the following rules (together with those discussed in §7.34A) are most often applicable:

- An individual is located at the individual's principal residence. Com C §9307(b)(1). This is subject to the special rule for non-U.S. debtors discussed in §7.34A.
- If a "registered organization" (*i.e.,* an organization organized solely under the law of a single state or the United States and as to which the state or the United States must maintain a public record showing the organization to have been organized) (Com C §9102(a)(70)) is organized under the laws of a "state" (which means a U.S. state, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, or any U.S. territory or possession) (Com C §9102(a)(76)), the organization is located in that state (Com C §9307(e)). By definition, the term "registered organization" excludes non-U.S. debtors. Com C §9102(70). See the discussion of non-U.S. debtors in §7.34A.
- An organization other than a registered organization is ordinarily located at its place of business if it has only one place of business, and is located at its chief executive office if it has more than one place of business. Com C §9307(b)(2)-(3). This is subject to the special rule for non-U.S. debtors discussed in §7.34A.

The location rule for "registered organizations" is a significant change from prior law. Previously, the debtor's state of registration was irrelevant. When filings were to be made in the state where the debtor was located (see former Com C §9103(3)(a)), the debtor's place of business or, if more than one, its chief executive office controlled. Former Com C §9103(d).

EXAMPLE: A California lender makes a loan in California to a borrower with operations, property, and offices only in California. The loan is secured by California real property, associated personal property located only in California, and accounts and general intangibles. The debtor is a Delaware limited liability company with its place of business only in California. Because the debtor's location controls, and the debtor is a Delaware registered organization, Delaware is the proper place to file the financing statement, not (as under prior law) California.

PRACTICE TIP: California loan transactions frequently involve borrowers registered in other states, and thus out-of-state filings are often required. When that occurs, lenders may need to retain local counsel in the state of the borrower's registration to be sure to comply with the laws of that state.

WARNING: Just as it is critical to ascertain a debtor's correct legal name (see §7.32), it is likewise essential to ascertain the debtor's correct Article 9 "location." These two elements are the foundation of Article 9's filing system. Filing under the wrong name, or in the wrong jurisdiction, will render a financing statement ineffective. The attorney-drafted security agreement forms in this chapter (§§7.47-7.77) include representations and warranties by the borrower as to its state of organization. See §7.74. In addition, careful lender's counsel will

obtain documentation from that state to confirm the information if the borrower is a registered organization. If the borrower is not a registered organization, other due diligence will be necessary to ascertain "location," and if there is any uncertainty (*e.g.,* as to "chief executive office" or "principal residence"), filings should be made in multiple states.

If a borrower changes its Article 9 "location" postclosing, the security interest remains perfected only until the expiration of 4 months after the change (Com C §9316(a)(2)), unless reperfected under the law of the new location within that time (Com C §9316(b)). Regarding the effect of transfers of collateral to a new debtor in a new location, see Com C §§9316(a)(3), 9507(a)-(b), 9508.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.34A (2) As Between Jurisdictions: Special Rules for Non-U.S. Debtors

§7.34A (2) As Between Jurisdictions: Special Rules for Non-U.S. Debtors

A non-U.S. debtor's location is determined by the place-of-residence rule (for individuals) or the place-of-business and chief-executive-office rules (for organizations) described in §7.34 only if the debtor is located in "a jurisdiction whose law generally requires information concerning the existence of a nonpossessory security interest to be made generally available in a filing, recording, or registration system as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral." Com C §9307(c). If that test is not met, the debtor is deemed located in the District of Columbia. Com C §9307(c). Commercial Code §9307 also provides special location rules applicable to non-U.S. banks with U.S. branches and non-U.S. air carriers. Com C §9307(i)-(j). Determining whether the test of Com C §9307(c) is met by the laws of a foreign jurisdiction can be exceedingly difficult and uncertain. See Rosenberg, *Classification of Foreign Filing Systems,* in S. Sepinuck, ed., Practice Under Revised Article 9 (ABA 2008); Rosenberg, *Where to File Against Non-U.S. Debtors: Applying UCC 9-307(c) [Rev] to Foreign Filing, Recording and Registration Systems*, 39 UCC LJ 109 (2006).

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§7.35 (3) Within a State

Revised Article 9 contemplates a single statewide office for filing most financing statements. UCC §9-501(a)(2). In California, as in many other states, this statewide office is the office of the Secretary of State. Com C §9501(a)(2). (On the proper place to file financing statements filed as fixture filings, typically the office of the County Recorder, see §§7.41-7.41A.)

Thus, *when California is the proper state in which to file a financing statement* (see §7.34-7.34A), the office of the California Secretary of State is the proper place to file. It must be emphasized, however, that this provision applies only "if the local law of *this state* governs perfection." Com C §9501(a). When the debtor is a corporation, limited liability company, or other organization registered in another state, the local law of "this state"—*i.e.*, California—does *not* govern perfection. See §7.34. In that event, the secured party must look to the other state's version of UCC §9-501(a) to learn the proper place to file in that state.

NOTE: Uniform Commercial Code §9-501(a)(2) is the general rule governing where to file within a state, but UCC §9-501(b) provides a special rule for filings covering collateral of a "transmitting utility" (defined in UCC §9-102(a)(80)), which applies to both fixture and nonfixture filings. As enacted in California, this special rule points to the same office for filing as does the general nonfixtures rule: the office of the Secretary of State. Com C §9501(b). The same may not be true in all states, however. For further discussion of the special rules applicable to transmitting utilities, see §7.41A. As with the general rule of Com C §9501(a), the special rule of Com C §9501(b) applies only if California is the proper state in which to file the financing statement; if another state is the proper place for filing and the debtor is a "transmitting utility," then that other state's version of UCC §9-501(b) will apply. See §§7.34-7.34A, 7.41A.

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§7.36 b. When to File

The financing statement should be filed immediately on closing the loan (if not before; see §7.44). A delay can cause a loss of priority to intervening interests (Com C §§9317, 9322) and could render the security interest potentially avoidable as a preference in a bankruptcy commenced even *after* the delayed filing is made. See 11 USC §547(b)(2), (e)(1)-(2).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.37 3. Filing Continuation Statements

§7.37 3. Filing Continuation Statements

A financing statement is normally effective for 5 years after it is filed, but its effectiveness then lapses unless a "continuation statement" is filed during the 6-month period before the 5-year period expires. Com C §9515(a), (c)-(e). (Regarding longer-duration rules applicable to public financing transactions, manufactured home transactions, and debtors that are transmitting utilities, see Com C §9515(b), (f), and §7.31.) When a financing statement lapses, it becomes ineffective and any security interest that was perfected by it becomes unperfected unless the security interest is perfected otherwise. Com C §9515(c). New continuation statements must be filed every 5 years. Com C §9515(e).

Under Com C §9102(a)(27), a continuation statement is an amendment of a financing statement that

- identifies, by its file number, the initial financing statement to which it relates; and
- indicates that it is a continuation statement for, or that it is filed to continue the effectiveness of, the identified financing statement.

Commercial Code §9521(a) sets out forms of financing statement amendment (Form UCC3) that the filing office may not refuse to accept. Use of these forms, while not required, is advisable and is common practice.

PRACTICE TIP: Lender's counsel should have an explicit understanding with the lender regarding who is responsible, counsel or lender, for calendaring and timely filing continuation statements. This task is usually best left to the lender, who may maintain a calendaring system specifically for this purpose on all its loans. Good practice is for counsel to advise the lender in writing, immediately after the loan closing, of the need to file continuation statements, the deadlines for filing, and counsel's understanding about who is responsible for calendaring and filing. See *Barnes v Turner* (Ga 2004) 606 SE2d 849 (when loan repayment could extend over 5 years, it is malpractice if creditor's lawyer does not either advise client that continuation statements must be filed every 5 years or actually make continuation filing on client's behalf at appropriate time; statute of limitations on this malpractice claim begins to runs not at time of initial transaction, but when lawyer, having failed to so advise client, should have made continuation filing 5 years later).

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D. Fixtures

§7.38 1. General Principles

Fixtures are goods that become so related to particular real estate that an interest in them arises under real estate law. Com C §9102(a)(41). See also CC §660, specifying when a thing is deemed to be affixed to land and is thus a real estate fixture.

In general, the creation and transfer of interests in or liens on real estate are excluded from the scope of Commercial Code Division 9. Com C §9109(d)(11). With fixtures, however, Division 9 ventures significantly into real estate territory. A security interest in fixtures (other than ordinary building materials incorporated into an improvement on land) can be created under Division 9 (Com C §§9109(a)(1), (d)(11)(B), 9334(a)) even though fixtures can also be encumbered under real estate law, such as by a deed of trust (see Com C §9334(b)). Further, Division 9 governs two types of priority contests involving fixtures:

- Contests between multiple competing Division 9 security interests in fixtures, which are governed by Division 9's normal priority rules, principally Com C §9322; and
- Contests between a Division 9 security interest in fixtures and a real estate law interest in fixtures, which are governed by the special rules of Com C §9334(c)-(f).

Division 9 does not govern contests between competing multiple real estate law interests in fixtures, which are left to real estate law.

The rules for priority contests of the second type mentioned (*i.e.,* contests between Division 9 security interests and real estate law interests) bring into play a special type of financing statement that is filed as "fixture filing." Com C §9102(a)(40). (The required contents of a financing statement filed as a fixture filing are discussed in §7.40; the place to make a fixture filing is discussed in §§7.41-7.41A.) The general rule for such priority contests is that a perfected security interest in fixtures has priority over a conflicting interest of an encumbrancer or owner of the real property if (Com C §9334(e)(1))

- the debtor has a record interest in or is in possession of the real property;
- the security interest is perfected *by a fixture filing* (as distinguished from perfection by another method, see §7.39) before the interest of the encumbrancer or owner is of record; and
- the security interest has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner.

For a discussion of this general priority rule and the other priority rules governing fixtures, in Com C §9334(c)-(h), see Secured Transactions in California Commercial Law Practice, chap 4 (2d ed Cal CEB 2001).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/ 2. Perfecting a Security Interest in Fixtures/§7.39 a. Alternative Methods of Perfection

2. Perfecting a Security Interest in Fixtures

§7.39 a. Alternative Methods of Perfection

A Division 9 security interest in fixtures normally may be perfected by any one of three methods:

- **Regular filing.** The security interest may be perfected by the filing of an ordinary financing statement (*i.e.,* one not filed as a fixture filing) that meets the requirements discussed in §§7.31-7.33. The rules that govern the place of filing such a financing statement are those that apply to financing statements generally. See §§7.34-7.35. Thus, such a financing statement would be filed in the state of the *debtor's* location, typically with the office of the Secretary of State in that state, even if the fixtures are not located in that state. Com C §§9301(1), 9501(a)(2). (This method of perfection appears not to apply, however, if the debtor is a "transmitting utility," as defined in Com C §9102(a)(80). See §7.41A.)
- **Fixture filing.** The security interest may be perfected by a fixture filing, *i.e.,* a financing statement that includes additional required information as discussed in §7.40, which, in California, is normally filed in the County Recorder's office where the related real estate is located, see §7.41. Com C §9501(a)(1)(B).
- **Deed of trust effective as fixture filing.** A mortgage or deed of trust will itself be effective as a fixture filing under Division 9 from the date of its recordation if it complies with the requirements of Com C §9502(c). See §7.40A.

Any of these three methods will perfect the Division 9 security interest, but there is an important difference in protective effect. Only the fixture-filing method, or a recorded deed of trust that complies with Com C §9502(c) and is thus effective as a fixture filing, will achieve priority under Division 9 over certain conflicting interests in the fixtures arising under real estate law—specifically, in any contest with real estate interests in which Com C §9334(d)-(e) requires that the Division 9 security interest have been "perfected by a fixture filing." Compare Com C §9334(e)(1)(A) ("perfected by a fixture filing") with Com C §9334(e)(3) ("perfected by any method permitted by this division").

NOTE: It is standard practice for real estate lenders (particularly institutional lenders) to make Division 9 fixture filings or to comply with Com C §9502(c) within the deed of trust so that it is effective as a fixture filing. It is worth noting, however, that a real estate secured lender is also obtaining and perfecting a security interest in the fixtures *under real estate law* by virtue of its recorded encumbrance on the associated real property, even if it makes no Division 9 fixture filing and its deed of trust does not comply with Com C §9502(c). Thus, complying with Division 9 in regard to fixtures may be unnecessary in most circumstances. Doing so is nonetheless advisable because there may be some limited situations in which enhanced priority could result.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.40 b. Required Contents of a Fixture Filing

§7.40 b. Required Contents of a Fixture Filing

The term "fixture filing" means the filing of a financing statement covering goods that are or are to become fixtures and containing the normally required elements of a financing statement as well as certain additional elements. Com C §9102(a)(40). Thus, a financing statement filed as a fixture filing must have the nine items of information listed in §7.31. Com C §§9502(a), 9516(b). In addition (except in the case of a debtor that is a "transmitting utility," noted below), it must do the following (Com C §9502(b)):

- Indicate that it covers fixtures;
- Indicate that it is to be recorded in the real property records;
- Provide a description of the real property to which the fixtures are related "sufficient to give constructive notice of a mortgage under the law of this state if the description were contained in a mortgage of the real property"; and
- If the debtor does not have a record interest in the real property, provide the name of a record owner.

NOTE: When the debtor is a "transmitting utility," as defined in Com C §9102(a)(80), a fixture filing need not include the additional details normally required, *e.g.,* an indication that fixtures are covered, or a description of the real property. See Com C §§9102(a)(40), 9502(a)-(b); discussion in §7.41A.

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§7.40A c. Deed of Trust Effective as a Fixture Filing

Conveniently, in real estate loan transactions the benefits of a fixture filing can be obtained without making a separate, stand-alone fixture filing. Commercial Code §9502(c) provides that a mortgage or deed of trust is itself "effective, from the date of recording, as a financing statement filed as a fixture filing," if all the following conditions are met:

- The mortgage or deed of trust indicates the goods that it covers;
- The goods "are or are to become fixtures related to the real property described in the mortgage" or deed of trust;
- The mortgage or deed of trust satisfies the requirements set forth in §9502(c) for a financing statement filed as a fixture filing other than an indication that it is to be filed in the real estate records (*i.e.,* the mortgage or deed of trust provides the debtor's and secured party's names, indicates the collateral covered, indicates that it covers fixtures, adequately describes the real property, and, if the debtor does not have a record interest in the real property, provides the name of a record owner); and
- The mortgage or deed of trust is duly recorded.

The form deed of trust in chap 4 illustrates how these requirements are met. See §§4.40, 4.82.

There are two advantages to complying with §9502(c) in the deed of trust. It eliminates the need for a separate fixture filing. It also eliminates the need to file continuation statements for the fixture filing, which otherwise would be necessary every 5 years. Com C §9515(a), (g). See §7.37.

PRACTICE TIP: Commercial Code §9502(c) requires that the mortgage or deed of trust satisfy only the requirements for a fixture filing set out "in this section," *i.e.,* §9502. Those requirements do not include the additional information normally required for a fixture filing (and any other financing statement) by Com C §9516(b), such as the debtor's organizational identification number. See §7.31. However, if the deed of trust states (as many do) that it "is" a fixture filing, it is probably advisable to include the Com C §9516(b) information.

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d. Where to Make Fixture Filings

§7.41 (1) In Jurisdiction Where Fixtures Are Located

As discussed in §7.34, the general rule is that regular financing statements are to be filed in the jurisdiction where the *debtor* is located. Com C §9301(1). That general rule also applies to financing statements that cover fixtures, but that are *not filed as fixture filings*. Compare Com C §9301(1) with §9301(3)(A), and see Com C §9501(a)(2). See §7.39.

A different rule applies, however, to fixture filings. A fixture filing is to be made in the jurisdiction where the *fixtures* are located. Com C §9301(3)(A). Thus, to perfect a Division 9 security interest in fixtures located in California, the fixture filing is to be made in California, no matter where the debtor is located.

PRACTICE TIP: In most real property secured transactions involving personal property, some of the personal property will be fixtures and some will not; and for some items, the proper categorization will be unclear. As a result, it is good practice to perfect under both sets of rules so that the security interest is perfected no matter how the collateral may be characterized.

When California is the proper state in which to make a fixture filing, then the filing is to be made in the same County Recorder's office where a mortgage on the related real property would be recorded (Com C §9501(a)(1)(B)), except if the debtor is a "transmitting utility" (see §7.41A).

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§7.41A (2) Special Rules for Transmitting Utilities

A "transmitting utility" is defined in Com C §9102(a)(80) to mean a person primarily engaged in the business of operating a railroad, subway, street railway, or trolley bus, transmitting communications electrically, electromagnetically, or by light, transmitting goods by pipeline or sewer, or transmitting or producing and transmitting electricity, steam, gas, or water. If a financing statement covers goods of a transmitting utility that are or are to become fixtures, the filing of that financing statement is, by definition, a fixture filing, even though it is not required to contain, and does not contain, the additional details normally required for a fixture filing, including real property descriptions. Com C §9102(a)(40). See §7.40.

To perfect a security interest in fixtures of a transmitting utility, the state in which to make the fixture filing is the state in which the fixtures are located, as is the rule for all fixture filings. See UCC §9-301(3)(A), discussed in §7.41. But the place *within* that state to make the fixture filing is governed by the special rule of UCC §9-501(b), as adopted by that state. In California, *e.g.,* filings covering the collateral of a transmitting utility, including fixtures, must be made with the Secretary of State, not with the County Recorder. Com C §9501(b). Most state enactments of UCC §9-501(b) are similar. The reason for this special rule is that many transmitting utilities have fixture assets spread across numerous real property parcels and counties, and even multiple states. Single state-wide filings, one per state, without real property descriptions, are far better suited to that situation.

PRACTICE TIP: Keep in mind several important points regarding the special rules for transmitting utilities:

- The definition of a "transmitting utility" covers a significant range of businesses, and does not require that the business be regulated as a public utility. Lender's counsel should be alert to identify borrowers who do not fit the classic concept of a utility but are, nonetheless, within the UCC definition.
- When it is unclear whether a borrower is a transmitting utility, prudence dictates that counsel comply with *both* sets of place-to-perfect rules: the general rules and the special rules for transmitting utilities.
- By definition, *any* filing of a financing statement covering goods of a transmitting utility that are to become fixtures is a "fixture filing." Com C §9102(a)(40); see also Com C §9501(b). As a result, an Article 9 security interest in fixtures of a transmitting utility presumably can be perfected by filing (1) *only* in the state where the fixtures are located, and (2) in the office specified by that state's version of UCC §9-501(b) (and not, as with other debtors, by a regular filing in the regular place; see §7.39).
- A security interest in *non*fixtures personal property collateral of a transmitting utility will be subject to the normal rules for determining the state in which to file (see §7.34); within that state, the place to file will be as specified by that state's version of UCC §9-501(b), and not by the normal rule of UCC §9-501(a) (see §7.35).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.42 E. Continued Perfection of Pre-Effective-Date Security Interests

§7.42 E. Continued Perfection of Pre-Effective-Date Security Interests

Revised Division 9, which became effective July 1, 2001, made significant changes in the rules for perfecting security interests. Particularly important are the following (discussed in §§7.34-7.35):

- The change in the proper place for filing financing statements for most tangible collateral, from the state where the collateral is located to the state where the debtor is located. Compare Com C §9301(1) with former Com C §9103(1)(b).
- The change in the rule for determining the location of a registered organization, which now locates the debtor in its state of registration. Compare Com C §9307 with former Com C §9103(3)(d).

A complete discussion of revised Division 9's transition rules (Com C §§9701-9709) is beyond the scope of this book. However, the following is a summary of transition rules of particular importance to lender's counsel doing due diligence to ascertain the existence, perfection, and priority of security interests that pre-dated revised Division 9 (see §§7.43-7.44):

(a) As a general rule, revised Division 9 applies to all security interests within its scope, even those created before the statute's effective date of July 1, 2001. Com C §9702(a). As a result, a lender who made a pre-effective-date loan *may* have had to take action to reperfect, under the revised law, a security interest that previously was perfected in compliance with prior law.

(b) If a security interest was perfected under prior law, and the steps that were taken to perfect it would also perfect the security interest under the revised law, then the security interest remained perfected after June 30, 2001, without further action. Com C §9703(a).

(c) A financing statement filed before July 1, 2001, remained effective to perfect a security interest after that date to the extent that the filing would satisfy the perfection requirements of the revised law. Com C §9705(b). This is true even if the filing was ineffective under prior law at the time it was filed. See UCC §9-705 Official Comment 3.

EXAMPLE 1: Before July 1, 2001, a lender obtained a security interest covering tangible personal property located in California. The borrower was a Delaware limited liability company, and the lender mistakenly filed a financing statement in Delaware, rather than (as required by former Com C §9103(1)(b)) in California. Although the Delaware filing did not perfect the security interest under prior law, it became effective to perfect as of July 1, 2001 (if it contained the information required by the revised law), because the revised law requires filing in Delaware. On priority of the security interest, see Com C §9709.

(d) A financing statement filed in the proper jurisdiction under prior law remained effective, for a time, even if the proper place for filing changed under the revised law. Com C §9705(c). Such a financing statement would have become ineffective, however, at the earlier of June 30, 2006, or the time it would have ceased to be effective under the prior law of the jurisdiction in which it was filed, unless, before that time, the lender took steps to continue its effectiveness as discussed below. Com C §9705(c)(1).

EXAMPLE 2: A financing statement was properly filed in California before July 1, 2001. The borrower is a Delaware limited liability company. The financing statement continued to be effective after July 1, 2001, even though Delaware would now be the proper location for filing. But it became ineffective on expiration of the 5-year period of effectiveness that applied to it under former Com C §9403(2) unless its effectiveness was timely continued under the rules discussed below.

(e) To determine whether the effectiveness of a pre-effective-date financing statement was properly continued, it must first be determined whether the applicable place of filing changed under the revised law. See §7.34. If it did *not* change (same state and same filing office), then the effectiveness of a pre-effective-date financing statement filed in that place would be continued by a continuation statement timely filed in that same place, if the continuation statement

complied with the revised law and if the financing statement and continuation statement, taken together, included all the information required for financing statements under the revised law. Com C §9705(d), (f). A continuation statement would *not* have been effective in Example 2 because the proper place of filing changed.

(f) If, as in Example 2, the proper place of filing *did* change under the revised law, the effectiveness of a pre-effective-date financing statement would be extended only if the secured party timely filed a new initial financing statement in the place dictated by the revised law. Com C §9706(a). (Thus, in Example 2, the place of filing would be Delaware.) The new financing statement would have had to do the following (Com C §9706(c)):

- Comply with the revised law's requirements for financing statements (see §§7.31-7.33);
- Identify the pre-effective-date financing statement by indicating the office in which it was filed and providing the dates of filing and file numbers of the financing statement and the most recent continuation statement (if any); and
- Indicate that the pre-effective-date financing statement remains effective.

(g) If a new initial financing statement was filed in accordance with the foregoing rules, then under Com C §9706(b)(2) it continued the effectiveness of the pre-effective-date financing statement for the period applicable to financing statements under revised Com C §9515, *i.e.,* generally 5 years commencing on the filing of the new initial financing statement, subject to further continuation. See §7.37. On amendments of pre-effective-date financing statements, see Com C §9707.

(h) If a security interest was perfected *other than by filing* under prior law but would no longer be perfected because the method of perfection has changed under the revised law, then the security interest remained perfected for only 1 year after the statute's effective date, *i.e.,* until July 1, 2002, unless perfection occurred before then under the revised law. Com C §9703(b).

EXAMPLE 3: A lender held a pre-effective-date security interest in a deposit account, which (in California) was perfected by notice to the bank holding the deposit under former Com C §9302(1)(g)(ii). Under current Com C §§9312(b)(1) and 9314, a security interest in a deposit account must be perfected by control (*e.g.,* by a control agreement such as that in §7.80). Thus, if the lender did not obtain control perfection by July 1, 2002, the security interest will have become unperfected. Com C §9703(b).

(i) If a secured party failed to timely continue the effectiveness of pre-effective-date perfection under the rules described above, but eventually did perfect under revised Article 9, then the security interest will be perfected as of that time but perfection will not date back.

As a general rule, revised Division 9 governs all priority contests, even those involving a security interest perfected before the statute's effective date, July 1, 2001. Com C §9709(a). Former Division 9 governs, however, if the relative priorities of competing claims were established before July 1, 2001, and are not reestablished under revised Division 9. Com C §9709(a) and UCC §9-709 Official Comment 1. See also Com C §9709(b) and UCC §9-709 Official Comment 2, on the priority of a security interest that attaches after July 1, 2001 (*e.g.,* under an after-acquired property clause), but for which

- a filing was made before July 1, 2001;
- the filing was ineffective to perfect at the time made; and
- the filing would be effective to perfect under revised Division 9.

WARNING: The discussion in this section assumes that all relevant jurisdictions adopted revised UCC Article 9 in essentially the same form as adopted in California. There are some state-to-state variations, however, so lenders should consult with local counsel in each relevant jurisdiction to make a full transition analysis.

For additional discussion of transition issues, see Sigman & Smith, *Revised U.C.C. Article 9's Transition Rules: Insuring a Soft Landing*, 55 Bus L 1065 (2000)(pt. I), and 55 Bus L 1763 (2000)(pt. II).

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F. Due Diligence Regarding Priority of Lender's Security Interest

§7.43 1. Overview

Before closing a loan involving significant personal property collateral, lenders typically undertake due diligence to ascertain, to the extent possible, whether its security interest will have the expected priority once it closes the loan and files the financing statement. Such due diligence involves five principal steps:

(1) Ascertain the personal property collateral to be included in the transaction (see §7.11) and the categorization of such collateral under Division 9 (see §§7.5, 7.23-7.30);

(2) Identify every relevant jurisdiction whose law might govern the perfection of prior security interests in and other liens and claims against that collateral (see §7.34), including interests perfected before revised Article 9's effective date (see §7.42);

(3) Ascertain the methods by which, and the places in which, competing security interests in and other liens and claims against that collateral would be perfected under the laws of all such jurisdictions (see §7.35);

(4) Make searches and inquiries as necessary in all such jurisdictions to determine whether competing security interests and other liens and claims have, in fact, been perfected (see §7.44); and

(5) Address the consequences of any competing interests that may be discovered (see §7.45).

PRACTICE TIP: UCC insurance is available from major land-title companies to insure (with various exceptions) the attachment, perfection, and priority of a lender's security interest in personal property. In transactions involving significant personal property (or property that might constitute fixtures, but arguably could be classified as nonfixtures personal property), UCC insurance is well worth considering. It typically will provide better protection, at lower cost, than opinions of counsel. See Murray, *Benefits of the UCC Insurance Policy,* in Modern Real Estate Transactions (ALI-ABA 2007).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.44 2. Searches for Competing Interests

§7.44 2. Searches for Competing Interests

The due diligence search for competing interests in collateral will include, at a minimum, requests to the Secretary of State (or comparable filing office) in every relevant jurisdiction for information on file against the borrower. Regarding the jurisdictions and offices in which UCC Article 9 filings are proper, and thus where searches should be made, see §§7.34-7.35, 7.39, 7.41-7.42; and see §7.44C regarding locations to search for IRS tax liens on personal property.

NOTE: Revised UCC Article 9 provided a 5-year grace period during which financing statements filed before the law's effective date, July 1, 2001, could remain effective (subject to expiration under prior law) even if filed in a jurisdiction other than the one specified by the revised law. That grace period ended June 30, 2006, in California and all but a very few other states. UCC §9-705(c); Com C §9705(c). See §7.42. Thus, the jurisdictions and offices in which due diligence searches for Article 9 filings are to be conducted should now be governed entirely by revised Article 9.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.44A (a) Secretary of State Searches; Financing Statements and Liens

§7.44A (a) Secretary of State Searches; Financing Statements and Liens

Commercial Code §9523(c) states that the filing office shall provide, on request, information about financing statements on file. (The filing office is directed by statute to provide the information within 2 business days after receiving the request (Com C §9523(e)), subject to excused delay for various reasons (Com C §9524).) In California, the Secretary of State, on request, will also provide a combined report showing financing statements, state tax liens, attachment liens, judgment liens, and federal liens. Com C §9528. Follow-up inquiries with the borrower and other creditors may well be necessary, depending on what the search discloses.

Of course, the report provided by a Secretary of State is valid only through the date and time of the search, which is shown on the report. See Com C §9523(c)(1). If the lender files the financing statement thereafter, it is possible that competing interests may intervene. The best protection against this possibility is to file the financing statement *well before* the transaction closes, as permitted by Com C §9502(d), *then* to file a search request, and close the transaction only after the Secretary of State's report comes back showing the lender's own filing. This procedure works because priority generally dates from the time of filing. See Com C §9322(a)(1). (If the transaction fails to close and there is no outstanding obligation or commitment to make advances, the secured party must, on the debtor's demand, provide a termination statement. Com C §9513(c).) The more important the personal property in the transaction (see §7.11), the more important it may be for the lender to use this procedure (although it is actually seldom used in real estate loan transactions).

A search of a Secretary of State's records does not disclose all potential competing interests, however. For example:

- Competing security interests in some collateral (*e.g.,* goods, negotiable documents, instruments, money, and tangible chattel paper) may have been perfected by possession. See Com C §9313. In some circumstances, the secured party may wish to do (or retain an appropriate expert to do) a physical inspection of the principal collateral, to be sure that it exists and is in the debtor's possession.
- Competing security interests in some collateral (*e.g.,* investment property, deposit accounts, letter-of-credit rights, electronic chattel paper, or electronic documents) may have been perfected by control. See Com C §9314. Bank accounts are often important in real property transactions, and it may be necessary to make inquiries of banks holding the debtor's deposit accounts to determine the existence of security interests perfected by control.
- Competing security interests in an insurance policy may have been perfected by notice to the insurer. Com C §9312(a)(4).
- Security interests in some types of collateral (*e.g.,* motor vehicles, aircraft, registered copyrights) are not perfected by filing under Division 9. See §7.30. Searches may be necessary in other state or federal public offices.
- If the debtor acquired collateral other than as a "buyer in ordinary course of business," financing statements filed against prior owners of the collateral may remain valid to perfect security interests created by those owners. See Com C §§9315(a)(1), 9320, 1201(b)(9). A search under the debtor's name does not disclose such filings.
- There are circumstances under which perfection occurs, at least temporarily, without filing. See Com C §§9315(c)-(e), 9312(e)-(h).
- Lenders often also do litigation searches in relevant counties and federal district courts.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.44B (b) County Recorder Searches; Fixture Filings and Liens

§7.44B (b) County Recorder Searches; Fixture Filings and Liens

It is also important for the lender to learn whether any fixture filings or lien filings have been made with the relevant County Recorder's office. This search will routinely be made by the title company while it is preparing to issue the lender's title insurance policy. Fixture filings against transmitting utilities will be filed elsewhere, however. See §7.41A.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.44C (c) Search Cautions

§7.44C (c) Search Cautions

Uniform Commercial Code searches are made under the borrower's name, so it is essential to ascertain the full, correct, legal name under which to search, and to accurately enter that name in the search request. See §7.32. Even with the correct name, two additional cautions are relevant to the search:

- If a search under the correct name, using the filing office's standard search logic, would disclose a prior financing statement that has inaccuracies in the debtor's name, that financing statement may, nonetheless, be effective because the incorrect name will not be considered "seriously misleading." Com C §9506(b)-(c). The California Secretary of State's search logic is set out in the Uniform Commercial Code Administrative Rules available on the website listed in the Directory. There are differences in the search logic used by various states.
- If a prior IRS tax lien is filed under an incorrect name, even if a search under the borrower's correct name using the filing office's standard search logic would *not* disclose that lien, then it has been held that under federal law the IRS filing may be effective if a "reasonable and diligent search" would have revealed it. *U.S. v Crestmark Bank (In re Spearing Tool and Mfg. Co.)* (6th Cir 2005) 412 F3d 653, 656 (IRS lien filed under "Spearing Tool & Mfg. Company Inc." was effective even though a search under the debtor's correct, legal name, "Spearing Tool and Manufacturing Co.," would not have revealed it using the filing office's standard search logic). Thus, depending on the factual circumstances, the lender may need to expand its search beyond the borrower's exact legal name.

NOTE: The proper jurisdiction for the filing of, and thus searching for, federal tax liens is prescribed by federal law, not UCC Article 9. The jurisdiction for filing an IRS lien against tangible or intangible personal property is normally the state of "residence" of the taxpayer at the time the lien is filed. 26 USC §6323(f)(1)(A)(ii), (f)(2)(B). For this purpose, the residence of a corporation or partnership is the place where the principal executive office is located. 26 USC §6323(f)(2)(B). Within that jurisdiction, the office in which the lien is filed is "one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State." 26 USC §6323(f)(1)(A)(ii). The California statute specifies the Secretary of State's office for filings against corporations, LLCs, partnerships, trusts and estates (CCP §2101(c)(1)-(3)), and, for filings against any other type of entity, including individuals, the County Recorder's office in the entity's county of residence (CCP §2101(c)(4)). Because the federal tax lien "residence" rule differs from the Article 9 "location" rule, the two rules may specify different jurisdictions for filing. Searches in each may be appropriate.

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§7.45 3. Consequences of Discovering Senior Interest

Due diligence may reveal that collateral is subject to a senior security interest or is leased rather than owned by the borrower. (The distinction between a security interest and a lease can be a subtle one. See Com C §1203.) In either event, the lender's security interest would be junior in priority, which may not be acceptable to the lender. The loan may well have been underwritten on the assumption that the borrower owns all personal property free and clear.

If existence of a senior interest *is* acceptable to the lender consistent with the loan underwriting, and if the collateral is important, it is crucial for the lender to negotiate with the senior party an agreement that does the following:

- Certifies copies of the relevant senior documents as constituting the entire agreement, including any amendments;
- Certifies that the borrower is not currently in default;
- Gives the lender a right to notice if the borrower defaults;
- Gives the lender rights to cure any such default, and an extended period in which to do so if necessary (especially important with nonmonetary defaults that the lender cannot cure without having possession of the collateral);
- Assures the lender that the senior secured debt or lease will not be modified without the lender's consent;
- Provides that any new loan made by the senior party either will not be secured by the collateral or will be subordinate;
- Obligates the senior party to recognize the lender (or other foreclosure-sale purchaser) as its debtor or lessee after a foreclosure by the lender of its junior security interest; and
- If the senior interest is a lease, protects the lender against the consequences of possible termination of the lease in a bankruptcy of the borrower.

Such agreements can be quite elaborate and the risks and difficulties they entail for the lender are part of the reason the lender may simply not accept the existence of senior interests. Subordination is a possibility if the third party agrees. See Com C §§9339, 10311. Many lenders, however, require that the collateral be owned free and clear and may not accept senior *or* junior interests on the collateral.

In addition to these agreements between the lender and the third party, the loan documents should provide that a default on other interests in the collateral is a default on the loan. See paragraph 4.1.6 in §7.64.

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§7.46 IV. SECURITY AGREEMENT FORM

As discussed in §7.6, the security agreement form that follows would not be used in a transaction in which a deed of trust such as the form in chap 4 is used, because that deed of trust already incorporates a security agreement. This form might be used with a title company form of deed of trust or another deed of trust that does not include personal property. Alternatively, this security agreement form could be integrated into a combined deed of trust/security agreement. This form of security agreement should be used only to secure personal property in connection with real property. If a lender wants broader rights to collateral, counsel should consider using forms found in Secured Transactions in California Commercial Law Practice, chap 2 (2d ed Cal CEB 2001).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.47 A. Form: Opening Clause and Recitals

§7.47 A. Form: Opening Clause and Recitals

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.47-7.79.

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

7.47-1 Opening clause and recitals

SECURITY AGREEMENT

This Security Agreement (Agreement) is made as of _ _[*date*]**_ _, by _ _**[*name and capacity of borrower, e.g., XYZ Company, LLC, a California limited liability company*]**_ _ (Borrower), in favor of _ _**[*name and capacity of lender*]**_ _ (Lender).**

Recitals

This Agreement is made in connection with a promissory note dated _ _[*date*]**_ _, made by Borrower in favor of Lender in the principal amount of _ _**[*dollar amount*]**_ _ (the Note), and a deed of trust dated _ _**[*date*]**_ _, securing payment of the Note (the Deed of Trust).**

The Note, the Deed of Trust, this Agreement, and all other documents and instruments executed or to be executed by Borrower in favor of Lender in connection with the loan evidenced by the Note are referred to collectively in this Agreement as the Loan Documents.

The Deed of Trust encumbers the real property described in Exhibit A to this Agreement, which, together with all present and future appurtenances, buildings, structures, improvements, and fixtures, is referred to collectively in this Agreement as the Real Property.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.48 B. Form: Grant of Security Interest

§7.48 B. Form: Grant of Security Interest

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.47-7.79.

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7.48-1 Grant of security interest

1. Grant of Security Interest; Property Subject to Security Interest. Borrower hereby GRANTS to Lender a security interest in all of the following property, now owned or hereafter acquired (collectively, the Collateral), to secure the Obligations (as defined in paragraph 2):

Comment: On the granting language, see Com C §9102(a)(73); §7.8. On security interests in after-acquired collateral, see Com C §9204(a); §7.9.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/ C. Description of Collateral/§7.49 1. Form: Main Description of Collateral

C. Description of Collateral

§7.49 1. Form: Main Description of Collateral

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7.49-1 Main description of collateral

[*Add one of the following alternatives*]

[*Alternative 1: Detailed description of collateral*]

1.1. Tangible Property. All goods and tangible personal property (including all appliances, furniture, furnishings, fittings, machinery, fixtures, tools, inventory, materials, supplies, and equipment) now or hereafter located or installed on or attached or affixed to the Real Property or any Collateral, or used, necessary for use, or intended for use in connection with or otherwise relating in any way to the Real Property or any Collateral (including the ownership, design, development, construction, improvement, equipping, furnishing, use, leasing, operation, management, occupancy, financing, or sale of the Real Property or any Collateral), including all goods and tangible personal property (including all appliances, furniture, furnishings, fittings, machinery, fixtures, tools, inventory, materials, supplies, and equipment) for providing gas, light, heat, water, air-conditioning, ventilation, shade, refrigeration, laundry, dry cleaning, food preparation, food service, dishwashing, garbage disposal, trash removal, fumigation, pest control, vacuuming, cleaning, window washing, telecommunications, computer, elevator, escalator, transportation, parking, safety, security, alarm, maintenance, landscaping, repair, decoration, recreation, entertainment, or other utilities, services, facilities, or guest, tenant, visitor, or other accommodations of any kind at or for the Real Property;

1.2. Intangible Property. All intangible personal property, and all documentary, electronic, and other evidences and embodiments of any intangible personal property, relating in any way to or deriving from the Real Property or any Collateral (including the ownership, design, development, construction, improvement, equipping, furnishing, use, leasing, operation, management, occupancy, financing or sale, damage, destruction, condemnation, or taking of the Real Property or any Collateral), including (a) all names under which or by which any of the Real Property or the Collateral may at any time be operated or known, all rights to carry on business under any such names or any variants of such names, and all goodwill in any way relating to the Real Property or the Collateral; (b) all permits, licenses, variances, land use entitlements, approvals, consents, authorizations, franchises, and agreements; (c) all rights under any covenants, conditions, and restrictions or other matters of record; (d) all contracts (including construction, materials, architectural, service, engineering, consulting, leasing, financing, sale, surety, operating, management, maintenance, repair, and landscaping contracts); (e) all reserves, deferred payments, deposits, refunds, rebates, cost savings, letters of credit, rights to proceeds of letters of credit, and payments of any kind; (f) all disbursed proceeds of financing commitments; (g) all insurance policies and insurance proceeds; (h) all claims, causes of action, and recoveries by settlement or otherwise (including for any damage to, or loss, taking, or diminution in the value of, any of the Real Property or the Collateral, or for any breach or rejection in bankruptcy of any lease of any of the Real Property or Collateral); (i) all interests of Borrower under any leases of any personal property of any kind, including any options to purchase; (j) all inventions, patents, trademarks, trade names, trade symbols, trade secrets, trade dress, service marks, copyrights, and associated goodwill; (k) all applications for and registrations and licenses of any patents, trademarks, trade names, trade symbols, trade secrets, trade dress, service marks, or copyrights; and (*l*) all computer software, source codes, and supporting information;

1.3. Plans, Reports, Records, and Documents. All drawings, plans, specifications, tests, reports, studies, designs, data, appraisals, maps, surveys, engineering reports, promotional materials, business books and records, and other documents of any kind (in tangible, electronic, or other form) relating in any way to the Real Property or to any Collateral (including the ownership, design, development, construction, improvement, equipping, furnishing, use, leasing, operation, management, occupancy, financing or sale, damage, destruction,

condemnation, or taking of the Real Property or any Collateral);

1.4. Stock. All shares of stock or other evidence of ownership of any part of the Real Property or the Collateral that is owned by Borrower in common with others, including any water stock relating to the Real Property, and all documents and rights of membership in any owners' or members' association or similar group having responsibility for managing or operating any part of the Real Property or the Collateral;

1.5. Commercial Code Collateral Types. Without limiting any foregoing provision, and without limitation by any foregoing provision, all goods, accounts, documents, instruments, money, deposit accounts, chattel paper, investment property, letter-of-credit rights, and general intangibles, as those terms are defined in the California Commercial Code from time to time in effect, now or hereafter located or installed on or attached or affixed to the Real Property or any Collateral, or used, necessary for use, or intended for use in connection with or otherwise relating in any way to or deriving from the Real Property or any Collateral (including the ownership, design, development, construction, improvement, equipping, furnishing, use, leasing, operation, management, occupancy, financing or sale, damage, destruction, condemnation, or taking of the Real Property or any Collateral); and

[*Continue*]

[*Alternative 2: Collateral described by reference to Commercial Code*]

1.1. Commercial Code Collateral Types. All goods, accounts, documents, instruments, money, deposit accounts, chattel paper, investment property, letter-of-credit rights, and general intangibles, as those terms are defined in the California Commercial Code from time to time in effect, now or hereafter located or installed on or attached or affixed to the Real Property or any Collateral, or used, necessary for use, or intended for use in connection with or otherwise relating in any way to or deriving from the Real Property or any Collateral (including the ownership, design, development, construction, improvement, equipping, furnishing, use, leasing, operation, management, occupancy, financing or sale, damage, destruction, condemnation, or taking of the Real Property or any Collateral); and

[*Continue*]

Comment: On descriptions of collateral, see Com C §§9203(b)(3)(A), 9108; §§7.9-7.11. On Exhibit A, see §7.76.

The objective of the collateral description is to encompass every item and type of personal property, tangible or intangible, likely to relate in any way to the real property. Alternatives 1 and 2 above are two different approaches to that objective.

Alternative 1 reflects what has long been common practice. In paragraphs 1.1-1.4, Alternative 1 uses extensive nontechnical language to describe all the kinds of personal property likely to have some connection to a parcel of real property. Then, to achieve the same objective in a different way, and to pick up anything that may have been missed, paragraph 1.5 in Alternative 1 uses the defined terminology of the Commercial Code, reciting the Division 9 collateral types.

Revised Division 9 makes it clear that a detailed listing of collateral is not required. Com C §9108(b)(3) allows description by "type of collateral defined in this code." As UCC §9-108 Official Comment 2 indicates: "This section rejects any requirement that a description is insufficient unless it is exact and detailed (the so-called 'serial number' test)." Alternative 2 relies exclusively on the more streamlined, by-type approach.

Alternative 1 and Alternative 2 cover the identical collateral. Some lender's counsel will continue to prefer Alternative 1 because it makes emphatically clear to the borrower, in lay language, the intended breadth of the security interest. Other counsel will prefer the brevity of Alternative 2, and may view it as avoiding the possibility that a court might somehow conclude that, if a particular item was not within Alternative 1's detailed paragraphs 1.1-1.4, it was not covered (a conclusion that, because of paragraph 1.5, would be incorrect).

It should be noted that the list of Division 9 collateral types does not include, in either Alternative 1 (paragraph 1.5) or Alternative 2 (paragraph 1.1), commercial tort claims (see Com C §9102(a)(13)). Commercial Code §9108(e)(1) does not allow such claims to be identified merely by type. Specific identification is required.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.50 2. Form: Description of Proceeds

§7.50 2. Form: Description of Proceeds

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7.50-1 Description of proceeds

1._. <u>Proceeds, Receipts, and Revenues</u>. All proceeds, replacements, substitutions, products, accessions, and increases of any of the Collateral, and all receipts, revenues, rents, issues, and profits of operation, use, hiring, leasing, or licensing of any of the Collateral.

Comment: On proceeds, see Com C §§9102(a)(64), 9315; see §7.9. This paragraph would be used irrespective of whether Alternative 1or Alternative 2 in §7.49 is selected. Although proceeds of collateral are covered automatically by Com C §9315(a)(2), this paragraph reflects the nearly universal practice of specifically mentioning proceeds.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.51 3. Form: Optional Itemized Description

§7.51 3. Form: Optional Itemized Description

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7.51-1 Optional itemized description

[*If applicable, add the following option*]

[*Option: Itemize personal property in Exhibit*]

1._. Itemized Personal Property. Without limiting any part of the foregoing description, all personal property described in _ _[*e.g., Exhibit B*]_ _ to this Agreement, all of which property Borrower represents and warrants to Lender is presently owned by and in possession of Borrower.

[*Continue*]

Comment: This additional optional provision allows the lender to supplement the broad overall coverage of the form description with a list, in optional Exhibit B, of specific items. This option might be used in a transaction involving extensive personal property, when a detailed list or inventory might prevent later disputes about what collateral was there at the outset. It might also be used if the lender wants the borrower to represent and warrant that it does in fact own and have certain key items of personal property. This option is rarely necessary.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.52 D. Form: Identification of Secured Obligations

§7.52 D. Form: Identification of Secured Obligations

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7.52-1 Obligations secured

2. Obligations Secured. The security interest granted by this Agreement secures the payment, performance, observance, and satisfaction by Borrower of all of its obligations, covenants, agreements, and conditions under all the following and all modifications, amendments, renewals, replacements, and extensions of each of them (collectively, the Obligations):

2.1. Loan Documents. The Loan Documents _ _[*excepting only, e.g., environmental indemnity agreement*]**_ _; and**

2.2. Other Included Agreements. All other agreements to which Borrower and Lender may now or hereafter be or become parties that state that Borrower's obligations under such agreements are secured by this Agreement or by the Deed of Trust (collectively, the Other Agreements).

Comment: See Com C §1201(b)(35) and discussion in §7.13.

The bracketed optional language in paragraph 2.1 allows the lender to exclude certain obligations or documents from the secured obligations, as might be done with a separate unsecured environmental indemnity agreement. See §1.70 and chap 5A.

Note that paragraph 2.2 is *not* a "dragnet" provision but includes only such other obligations as may recite that they are secured by this security agreement or the deed of trust.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.53 E. Form: Protective Covenants

§7.53 E. Form: Protective Covenants

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7.53-1 Protective covenants

3. Borrower's Representations, Warranties, and Covenants. TO PROTECT AND MAINTAIN THE SECURITY OF THIS AGREEMENT, BORROWER AGREES:

3.1. Payment and Performance of Obligations. Borrower will promptly pay, perform, observe, and satisfy all Obligations when due.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.54 1. Form: Ownership, Maintenance, and Preservation of Collateral

§7.54 1. Form: Ownership, Maintenance, and Preservation of Collateral

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7.54-1 Ownership, maintenance, and preservation of collateral

3.2. Ownership, Maintenance, and Preservation of Collateral; Compliance With Law.

3.2.1. Borrower represents and warrants that it is (and as to any Collateral acquired hereafter agrees and warrants that it will at all times be and remain) the sole owner of the Collateral, free from any lien, security interest, or other claim, excepting only the security interest granted by this Agreement and the leasehold interests of tenants of the Real Property under leases of the Real Property that are permitted or not prohibited by the Loan Documents. Borrower represents and warrants that it has not executed or authorized the filing of any financing statement covering any of the Collateral except in favor of Lender, and that no financing statement covering any of the Collateral is on file in any public office in any jurisdiction. Without Lender's prior written consent, Borrower will not execute, file, or authorize to be filed, in any jurisdiction, any financing statement covering any of the Collateral in which Lender is not named as the sole secured party. Borrower represents and warrants that there is no personal property of any type or description that is leased to Borrower, and agrees and warrants that Borrower will not become the lessee of any personal property without Lender's prior written consent.

3.2.2. Borrower will maintain and keep the Collateral in good condition and repair and will not commit or permit any waste or unreasonable depreciation. Borrower will not alter, remove, or demolish any Collateral without Lender's prior written consent, except as may be required by law or permitted by other provisions of this Agreement.

3.2.3. Borrower will promptly replace every part of the Collateral that may be or become damaged, destroyed, consumed, worn out, lost, obsolete, or otherwise unfit for use in the operation of the Real Property, with other Collateral, which will be (a) in good operating condition, with a value and utility at least equal to that of the replaced Collateral in usable condition and good repair; and (b) owned by Borrower free and clear of all liens and encumbrances except the security interest granted by this Agreement, which will be perfected and in first priority. Borrower will promptly notify Lender if any damage to or loss of any of the Collateral occurs.

3.2.4. All tangible Collateral, and all tangible embodiments and evidences of intangible Collateral, will be and remain located on the Real Property, except as Lender may consent in writing. Borrower will not sell or remove from the Real Property any of the Collateral unless (a) such Collateral is inventory sold in the ordinary course of business and is promptly replenished with like Collateral of equivalent value in which Lender has a perfected first-priority security interest; (b) Lender has consented in writing, and under such conditions as Lender may impose; or (c) such Collateral is concurrently replaced with like Collateral of equivalent value and utility in which Lender has a perfected first-priority security interest.

3.2.5. Borrower will comply with all applicable laws, ordinances, regulations, covenants, conditions, restrictions, and requirements of governmental authorities now or hereafter affecting the Collateral (collectively, Applicable Law). Borrower agrees not to commit, suffer, or allow any act to be done in violation of Applicable Law and will make all payments required under Applicable Law, subject to Borrower's right of contest set forth in paragraph 3.4 below.

3.2.6. In the performance of all such acts and all other acts required by this Agreement, Borrower will promptly pay when due, at its own expense, all expenses incurred and will promptly pay, discharge, or otherwise satisfy all claims for labor performed and materials furnished in connection with the Collateral.

Comment: See §7.14 on protective covenants. If the borrower has previously financed or leased certain personal property, and if that is acceptable to the lender, paragraph 3.2.1 should be modified to reflect that fact. The lender will want protective agreements from the holder of the senior interest. See §7.45. Under Com C §9401(b), an agreement prohibiting a transfer of the debtor's rights in collateral or making the transfer a default does not prevent the transfer from taking effect.

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§7.55 2. Form: Entry and Inspections

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7.55-1 Entry and inspections

3.3. Entry and Inspections. Lender and its agents, attorneys, employees, and contractors may enter any part of the Real Property (and any other place where any of the Collateral is or may be located) at all reasonable times to attend to Lender's interests, inspect the Real Property and the Collateral, including all books, records, inventories, and other documents relating to the Real Property or the Collateral, or perform any other act that Lender is authorized to perform under this Agreement or by law. Borrower will cooperate in such entries and inspections as Lender may reasonably request.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.56 3. Form: Taxes, Assessments, Liens, and Security Interests

§7.56 3. Form: Taxes, Assessments, Liens, and Security Interests

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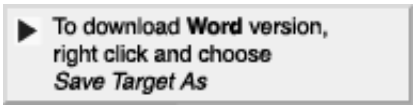

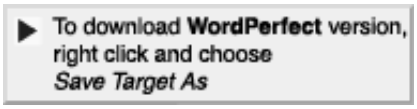

7.56-1 Taxes, assessments, liens, and security interests

3.4. Taxes, Assessments, Liens, and Security Interests. Borrower will pay when due all taxes and assessments against the Collateral and all claims and demands arising from Borrower's ownership or use of it, and will not cause or permit any lien or security interest to be imposed on or to exist against the Collateral, except that Borrower may withhold payment of any contested taxes, assessments, claims, or demands, or contest any lien, as long as (a) Borrower is diligently prosecuting its contest in good faith and in proper proceedings; (b) Borrower is not in default under any of the Obligations; (c) Lender's interest in the Collateral is not jeopardized; and (d) in any event, if any part of the Real Property or the Collateral is subjected to a lien not discharged within _ _[*e.g., 10*]_ _ calendar days after Borrower's knowledge of such lien, Borrower will deposit with Lender cash in an amount adequate to provide for, or will post a surety bond that causes, the discharge of the lien plus any interest, costs, attorney fees, or other charges that could accrue. Lender will have the right to apply any such deposited amounts to discharge the lien at any time if necessary to prevent enforcement of the lien, or to prevent accrual of interest, attorney fees, or other charges in excess of amounts on deposit, despite the pendency of any contest. In any contest, Borrower will defend itself and Lender at Borrower's expense and will satisfy any final adverse judgment before enforcement against the Collateral. Borrower will name Lender as an additional obligee under any surety bond furnished in the contest proceedings.

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§7.57 4. Form: Insurance

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7.57-1 Insurance

3.5. Insurance. Borrower will procure and maintain policies of fire, extended coverage, and other insurance in the form and from insurers acceptable to Lender, providing such coverage of the Collateral as Lender may from time to time require. All such policies will name Lender as additional insured and loss payee. Borrower will deliver to Lender certificates of coverage from each insurer, stipulating that coverage will not be canceled or diminished without at least _ _[*e.g., 30*]_ _ calendar days' written notice to Lender.

Comment: See §7.14 on protective covenants. Lenders' insurance requirements vary (***e.g.,*** cash value versus full replacement cost), so this clause leaves open the specifics of what will be required. A useful practice is for the lender to provide an insurance requirements letter, relating to both real and personal property, which borrower acknowledges by signing at or before the loan closing. Paragraph 3.5 permits the lender to change its insurance requirements from time to time. Borrowers sometimes seek to negotiate a limit on the lender's ability to impose increased insurance requirements in the future.

Regarding the statutory limitation on required hazard insurance on improvements, CC §2955.5, see §4.24.

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§7.58 5. Form: Litigation; Attorney Fees

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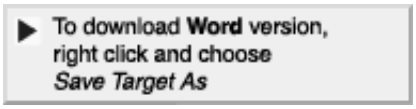

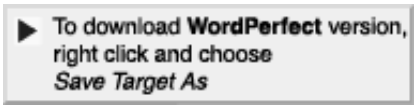

7.58-1 Litigation; attorney fees

3.6. Litigation; Attorney Fees.

3.6.1. Borrower will promptly notify Lender of the commencement or threat of commencement of any litigation that seeks to or could materially affect any of the Collateral, the security interest of this Agreement, or the rights or powers of Lender under this Agreement. Borrower will, at its own expense, appear in and defend any such litigation. Lender will also have the right, but not the obligation, to appear in any such litigation, and Borrower will pay all costs and expenses (including attorney fees) of Lender in so appearing.

3.6.2. If Lender uses legal counsel to enforce or prevent a breach of this Agreement or the Obligations, whether or not suit is filed, Borrower will immediately reimburse Lender for reasonably incurred attorney fees and other costs and expenses. Borrower will also immediately reimburse Lender for all attorney fees and costs reasonably incurred in connection with the representation of Lender in any bankruptcy, insolvency, reorganization, or other debtor-relief or similar proceeding of or relating to (a) Borrower, (b) any person liable (by way of guaranty, assumption, endorsement, or otherwise) on any of the Obligations (an Other Liable Party), (c) the Collateral, (d) the Real Property, or (e) any other property that secures any of the Obligations. All such amounts will be secured by this Agreement and will bear interest from the date of expenditure until reimbursed, at the rate from time to time applicable under the Note.

Comment: See §7.14 on protective covenants.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.59 6. Form: Lender's Right to Perform for Borrower

§7.59 6. Form: Lender's Right to Perform for Borrower

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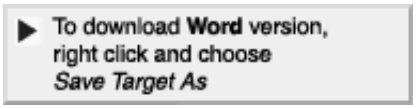

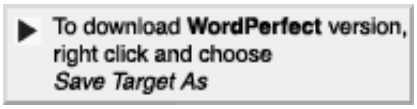

7.59-1 Lender's right to perform for borrower

3.7. Lender's Right to Perform for Borrower. If Borrower fails to make any payment, perform any Obligation, or do any act set forth in or secured by this Agreement, Lender, at Lender's option, without notice to or demand on Borrower and without releasing Borrower from the duty to make such payments, perform such Obligations, or do such acts, then or in the future, may make such payment, perform such Obligation or do such act in such manner and to such extent as Lender may deem necessary to protect the security of this Agreement. Without limiting any foregoing clause, Lender may pay, purchase, contest, or compromise any encumbrance, charge, or lien that, in Lender's sole judgment, appears to be prior or superior to this Agreement. In exercising any such power, Lender may pay all necessary expenses incurred, including reasonable attorney fees. Borrower will pay, immediately and without demand, all sums so expended by Lender with interest, from the date of expenditure, at the rate from time to time applicable under the Note.

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§7.60 7. Form: Third Party Agreements

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7.60-1 Third party agreements

3.8. Contracts, Leases, Permits, Licenses, Franchises. With respect to Collateral consisting of rights in or under agreements, contracts, leases, permits, licenses, franchises, and the like, now existing or hereafter acquired or entered into (collectively, Third Party Agreements):

3.8.1. Except with respect to Third Party Agreements of inconsequential value, the breach or loss of which could have no material adverse effect on Borrower, the Real Property, or any of the remaining Collateral, Borrower will, at its sole cost and expense (a) perform and satisfy every obligation and condition of the Third Party Agreements to be performed or satisfied by Borrower; (b) give prompt notice to Lender of any notice of default given or received by Borrower under any Third Party Agreements, together with a copy of any such notice of default; (c) enforce, short of termination, the performance and satisfaction of every obligation and condition of the Third Party Agreements to be performed or satisfied by the other parties to the Third Party Agreements; and (d) appear in and defend any action arising from or relating to the Third Party Agreements or the obligations of any party under any Third Party Agreement.

3.8.2. Except with respect to Third Party Agreements of inconsequential value, the breach or loss of which could have no material adverse effect on Borrower, the Real Property, or any of the remaining Collateral, Borrower will not, without Lender's prior written consent, take any action to (a) terminate or amend any Third Party Agreements; (b) waive or release the parties to any Third Party Agreements from any obligation or condition to be performed or satisfied by such parties; (c) make any other assignment or transfer of any of its rights in any Third Party Agreements, absolutely or for security; or (d) revoke or countermand, or attempt or purport to revoke or countermand, the irrevocable authorizations and instructions set forth in paragraph 3.8.3. Any such purported action by Borrower without Lender's prior written consent will be void and will constitute a default under this Agreement.

3.8.3. Borrower hereby irrevocably authorizes and instructs every present and future party under every Third Party Agreement, upon demand by Lender, to pay and perform all of such party's obligations directly and only to Lender, to recognize and accept Lender as the holder of all of Borrower's rights and benefits under the Third Party Agreement for all purposes, and to accept any payment or performance by Lender of Borrower's obligations under the Third Party Agreement that Lender may elect to tender. No such party shall have any duty to investigate the validity or accuracy of any such demand by Lender. Each such party shall be relieved of any liability to Borrower for payment or performance under a Third Party Agreement to the extent that such party has paid or performed to Lender, pursuant to demand of Lender, even if it is later determined that Lender's demand for payment or performance was invalid.

3.8.4. Lender is not obligated to perform any obligations of Borrower under any Third Party Agreement unless Lender so elects, and Borrower shall remain liable under every Third Party Agreement to the same extent as if this Agreement had not been executed. The exercise by Lender of any rights and remedies under this Agreement shall not release Borrower from any of its duties or obligations under any Third Party Agreement.

Comment: See §7.14 on protective covenants. When the collateral includes important Third Party Agreements (as, *e.g.,* in construction loans), lenders often obtain a separate assignment of each agreement, which will include provisions by which the third party consents to the assignment and agrees to terms protecting the lender. See §§7.7, 7.45, 9.9, 9.17, 9.19. For form collateral assignments, see §§9.47, 9.48.

The "except" clause that begins paragraphs 3.8.1 and 3.8.2 addresses the borrower's legitimate concern that it not

be placed in default by, *e.g.,* canceling a trivial contract. The scope of the "except" clause might be the subject of negotiations.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.61 8. Form: Borrower's Additional Performance

§7.61 8. Form: Borrower's Additional Performance

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7.61-1 Borrower's additional performance

3.9. Borrower's Additional Performance. Borrower will execute any and all further agreements, assignments (including separate assignments of Third Party Agreements), documents, financing statements, and authorizations of financing statements, and take such other further acts, as Lender may reasonably request from time to time, in order to evidence, protect, perfect, or continue the security interest of Lender in the Collateral or otherwise carry out the purposes and intent of this Agreement.

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§7.62 9. Form: Financing Statements

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7.62-1 Financing statements

3.10. Financing Statements. Borrower authorizes Lender to file financing statements in all states, counties, and other jurisdictions as Lender may elect, without Borrower's signature if permitted by law. At Lender's election, in addition to or instead of any other description of the Collateral, any financing statement description may use the terms "all assets," "all personal property," or words to similar effect _ _[*, relating in any way to the Real Property (including the ownership, design, development, construction, improvement, equipping, furnishing, use, leasing, operation, management, occupancy, financing or sale, damage, destruction, condemnation, or taking of the Real Property)*]**_ _.**

Comment: Revised Division 9 no longer requires the debtor's signature on financing statements, and the debtor's authentication of a security agreement automatically authorizes the secured party to file financing statements with respect to the collateral. Com C §9509(b). See §7.31. The first sentence of paragraph 3.10 nonetheless makes this authorization explicit.

The second sentence addresses the fact that although supergeneric "all assets" descriptions of collateral are not adequate in a security agreement (Com C §9108(c); see §7.9), they are permissible in a financing statement (Com C §9504(2); see §7.33). The lender may wish to use such a description because it provides the maximum possible notice to competing creditors. The express authorization of supergeneric descriptions in the second sentence of paragraph 3.10 is advisable because such a description may conceivably go beyond the reach of the security agreement.

If the borrower is a single-project entity whose only assets will be the real property and associated real property, it should have no objection to authorizing unlimited "all assets" filings. If the borrower has other properties, however, the filing of a financing statement with such a supergeneric description may interfere with its ability to obtain other financing. The bracketed language would address that issue.

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§7.63 10. Form: Indemnity

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7.63-1 Indemnity

3.11. Indemnity. Borrower will indemnify, defend, and hold Lender harmless from and against all liabilities, claims, actions, costs, and expenses, including attorney fees, arising from or related to Borrower's ownership or use of any of the Collateral, or Lender's exercise of any of its rights or remedies under this Agreement.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/ F. Events of Default and Remedies/§7.64 1. Form: Events of Default and Remedies

F. Events of Default and Remedies

§7.64 1. Form: Events of Default and Remedies

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7.64-1 Events of default and remedies

4. Default; Remedies.

4.1. Events of Default. Each of the following will constitute an event of default under this Agreement:

4.1.1. Borrower fails to pay any monetary amount due, as and when required, under this Agreement;

4.1.2. Borrower defaults under or fails to perform, observe, or satisfy when due any nonmonetary condition, covenant, or other provision of this Agreement; provided, however, that if the default in such nonmonetary condition, covenant, or obligation is reasonably susceptible of being cured, and is a default only under this paragraph 4.1.2 and no other provision of paragraph 4.1, and if Borrower is not otherwise in default under this Agreement, then Borrower will have _ _[*e.g., 30*]_ _ calendar days after written notice of the default in which to effect a cure, and, if such default is of such character as to reasonably require more than _ _[*e.g., 30*]_ _ calendar days to cure, Borrower will not be in default if Borrower commences to cure within such 30-calendar-day period, thereafter diligently continues such cure, and completes the cure within _ _[*e.g., 60*]_ _ calendar days after such notice;

4.1.3. Borrower takes or purports to take any of the actions prohibited by paragraph 3.8.2;

4.1.4. Any event of default occurs under any other Loan Document or Other Agreement, subject to any provision for notice and cure set forth in such Loan Document or Other Agreement;

4.1.5. Any representation or warranty in this Agreement or in any other instrument or agreement evidencing, securing, guaranteeing, or otherwise relating to any of the Obligations is or becomes untrue or misleading in any material respect;

4.1.6. Subject to Borrower's right to contest certain liens as provided in paragraph 3.4, any claim of lien is filed against any of the Collateral, or there is or occurs a default by Borrower under any lien, mortgage, security agreement, or deed of trust that Lender has permitted;

4.1.7. Borrower or any Other Liable Party ceases operations, is dissolved, or terminates its existence; or

4.1.8. Borrower or any Other Liable Party makes a general assignment for the benefit of creditors or generally is not paying, or is unable to pay, or admits in writing the inability to pay, its debts as they become due, or any bankruptcy, insolvency, reorganization, receivership, conservatorship, or debtor-relief proceeding is commenced with respect to Borrower or any Other Liable Party; provided, however, that if such a proceeding is commenced with respect to Borrower by a party other than Borrower or any of Borrower's general partners or members, or if such a proceeding is commenced with respect to any Other Liable Party by a party other than such Other Liable Party or any of such Other Liable Party's general partners or members, Borrower or such Other Liable Party will have _ _[*e.g., 60*]_ _ calendar days to have the proceeding dismissed or discharged.

Comment: See §7.15 on events of default.

Paragraph 4.1.2 provides a cure period for nonmonetary defaults. Some lenders have a more restrictive policy (and

some a more lenient policy) on cure periods than stated here. This topic is often the subject of negotiations.

Paragraph 4.1.4 is a "cross-default" provision, which assures that a default under any other loan document is also a default under the security agreement.

Paragraph 4.1.5 also cross-defaults the security agreement to any other encumbrances that have been permitted by the lender.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.65 2. Form: Lender's Remedies

§7.65 2. Form: Lender's Remedies

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7.65-1 Lender's remedies

4.2. Lender's Remedies.

4.2.1. If an event of default under this Agreement occurs, Lender may, at its sole option, without notice to or demand on Borrower, do any one or more of the following:

(a) Declare any or all of the Obligations immediately due and payable, regardless of any otherwise applicable maturity date;

(b) After giving such notice as may be required by law, if any, foreclose on, sell, lease, license, or otherwise dispose of, nonjudicially and/or by judicial action, in any order, separately or together, at the same or different times and places, any or all of the Collateral and/or the Real Property and/or any other real or personal property security for the Obligations, without waiving any other part of any of the Collateral, the Real Property, or any other such real or personal property security;

(c) Require Borrower to assemble any or all of the Collateral and make it available to Lender at a place designated by Lender that is reasonably convenient to Borrower and Lender;

(d) Without removal, render the Collateral unusable and dispose of it on the Real Property or other premises of Borrower without judicial process, if Lender can do so without a breach of the peace, or by judicial process;

(e) Enter on the Real Property (or any other property where any of the Collateral may be located) and possess and remove any or all of the Collateral without judicial process, if Lender can do so without a breach of the peace, or by judicial process;

(f) In any sale, lease, license, or other disposition of any Collateral, disclaim any or all warranties of any kind which by law may be disclaimed, and no such disclaimer shall be considered to affect the commercial reasonableness of such sale, lease, license or other disposition;

(g) Exclude Borrower and its successors or assigns, agents, and employees from the Collateral, and hold, store, use, operate, manage, and control the Collateral, and collect and receive all rents, revenues, issues, income, and profits of the Collateral;

(h) Exercise any or all other remedies now or in the future available to a secured party under the California Commercial Code;

(i) Obtain the appointment of a receiver ex parte and without prior notice to Borrower, which notice Borrower hereby waives;

(j) Obtain specific performance of any covenant or agreement contained in this Agreement, or in aid of the execution of any power or remedy granted in this Agreement; and

(k) Exercise any other legal, equitable, or contractual right or remedy against Borrower and/or any security and/or any Other Liable Party.

4.2.2. No remedy provided or permitted under this Agreement is exclusive of any other, or of any remedy

provided or permitted by law, equity, or any other instrument or agreement evidencing, securing, guaranteeing, or relating to any of the Obligations. Each remedy is cumulative and in addition to every other remedy. No exercise of remedies, including foreclosure, against any part of the Collateral will exhaust or extinguish Lender's rights to exercise remedies, including foreclosure, against the Real Property or any other part of the Collateral until the Obligations are paid in full. No exercise of remedies, including foreclosure, against any part of the Real Property will extinguish Lender's rights to exercise remedies, including foreclosure, against the Collateral or any other part of the Real Property until the Obligations are paid in full. Lender may exercise any one or more of its remedies at its option without regard to the adequacy of its security.

4.2.3. Lender's delay or omission in the exercise of any right, remedy, or power accruing on any event of default under this Agreement will not impair such right, remedy, or power or any other, nor will such delay or omission be deemed a waiver of or acquiescence in that or any other event of default.

Comment: See Com C §§9601-9629; §§7.16-7.18.

Paragraph 4.2.1(f) recognizes the secured party's right to disclaim warranties in a disposition of the collateral. See Com C §9610(d)-(f), and UCC §9-610 Official Comment 11.

The practitioner should be aware that foreclosure on mixed collateral may well affect the lender's remedies, depending on how it is accomplished, despite paragraph 4.2.2. See §7.17 on remedies available when an obligation is secured by both real and personal property.

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§7.66 3. Form: Use of Proceeds

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7.66-1 Use of proceeds

4.3. Use of Proceeds. The proceeds of any disposition or use of Collateral will be applied in the following priority: (a) to pay reasonable expenses of taking, holding, preparing for disposition, selling, using, leasing, licensing, otherwise disposing of the Collateral, and the like, including reasonable attorney fees and costs incurred by Lender; (b) to satisfy all remaining Obligations in such order as Lender may elect; and (c) to satisfy any indebtedness secured by any subordinate security interest in the Collateral, if an authenticated demand for such payment is received before distribution of the proceeds is completed. The disposition of any Collateral, the realization of any proceeds, the application of any proceeds, or any one or more of the foregoing shall not operate to cure any nonmonetary or monetary default in or reinstate the Obligations for any purpose, or otherwise affect in any way Lender's rights and remedies with respect to any remaining Collateral, any Real Property, or any other real or personal property security, except to the extent otherwise required by law.

Comment: On disposition of proceeds, see Com C §9608(a). On authentication, see §7.4.

Regarding the final sentence of Paragraph 4.3, see Com C §9604(a)(4), which is part of California's nonuniform mixed-collateral provisions. See §7.17. Note that Com C §9604(a)(4)(B) is silent on the effect of receipt and application of proceeds upon cure or reinstatement for purposes of exercising remedies against *real* property, but Com C §9604(a)(4)(C) at least suggests that this might be a proper subject for agreement of the parties. Compare these provisions of the Commercial Code with CC §2938(e) (in the context of assignments of rents, application of rents to the secured obligation "shall" be credited against amounts necessary to cure monetary default for purposes of reinstatement under CC §2924c, "notwithstanding any provisions of the assignment or other loan documents to the contrary"). See §5.7.

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G. Miscellaneous Provisions

§7.67 1. Form: Governing Law

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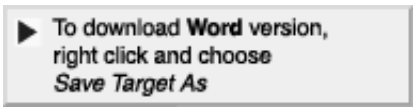

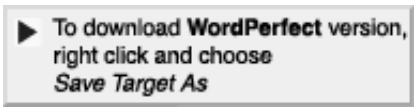

7.67-1 Governing law

5. Miscellaneous Provisions.

5.1. Governing Law. This Agreement has been executed and delivered in and is to be construed, enforced, and governed according to the laws of the State of California, without regard to the principles of conflict of laws.

Comment: Under Com C §1105(1), the parties may select the law of a state to which the transaction "bears a reasonable relation." The rules of Com C §§9301-9307 on which state's law governs the perfection of a security interest (see §7.34) cannot be changed by agreement, however. Com C §1105(2). For choice-of-law issues, see also §§3.48, 4.55.

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§7.68 2. Form: Entire Agreement; Modification

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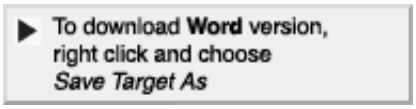

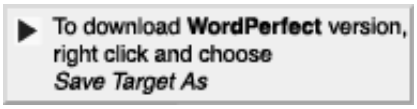

7.68-1 Entire agreement; modification

5.2. Entire Agreement; Modification. The Loan Documents collectively constitute the entire understanding between Lender and Borrower as to the matters contemplated in those documents and may not be modified, amended, or terminated except by written agreement signed by both parties.

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§7.69 3. Form: Partial Invalidity

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7.69-1 Partial invalidity

5.3. Partial Invalidity. If any provision of this Agreement or the instruments or agreements reflecting the Obligations are held to be invalid, illegal, unenforceable, or voidable in any respect, no other provision of this Agreement, or of any such other instrument or agreement, will be affected thereby, and such other provisions will remain binding and enforceable.

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§7.70 4. Form: Parties Benefited

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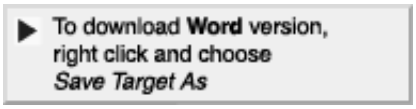

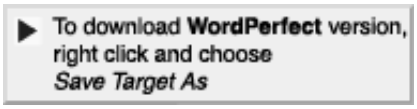

7.70-1 Parties benefited

5.4. Parties Benefited. This Agreement applies to, inures to the benefit of, and binds all parties to this Agreement and their respective heirs, legatees, devisees, administrators, executors, successors, and assigns (but this provision will not be interpreted to permit or validate any lien, encumbrance, assignment, or other transfer by Borrower that is prohibited by other provisions of this Agreement or other Loan Documents). "Lender" means the owner and holder, including pledgees, of any of the Obligations.

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§7.71 5. Form: Headings

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7.71-1 Headings

5.5. Headings. Headings are used for convenience of reference only and do not define or limit the scope of this Agreement.

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§7.72 6. Form: Written Notice; Delivery

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7.72-1 Written notice; delivery

5.6. Written Notice; Delivery.

5.6.1. All notices contemplated under this Agreement will be given in writing, and will be sent (a) for personal delivery by a delivery service that provides a record of the date of delivery, the individual to whom delivery was made, and the address where delivery was made; (b) by certified United States mail, postage prepaid, return receipt requested; or (c) by nationally recognized overnight delivery service, marked for next-business-day delivery, with all charges prepaid or billed to sender's account.

5.6.2. All notices will be addressed to the appropriate party at its address as follows or such other addresses as may be designated by notice given in compliance with this provision:

Lender: _____
_____
_____

Borrower: _____
_____
_____

5.6.3. Notices will be deemed effective on the earliest of (a) actual receipt; (b) rejection of delivery; (c) if sent by certified mail, the third day on which regular United States mail delivery service is provided after the day of mailing; or (d) if sent by overnight delivery service, on the next day on which such service makes next-business-day deliveries after the day of sending.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.73 7. Form: Joint and Several Obligations

§7.73 7. Form: Joint and Several Obligations

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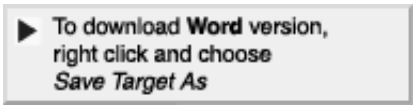

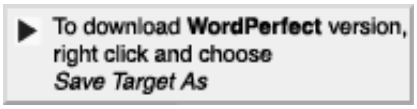

7.73-1 Joint and several obligations

5.7. Joint and Several Obligations. If more than one person has executed this Agreement as Borrower, the obligations of all such persons will be joint and several. Any married person who executes this Agreement agrees that recourse may be had against his or her separate property and against community property. If Borrower is a partnership, Borrower's obligations will be the joint and several obligations of all general partners in that partnership.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.74 H. Form: Borrower Identification Information; Nonconsumer Transaction; Changes in Name or State of Organization

§7.74 H. Form: Borrower Identification Information; Nonconsumer Transaction; Changes in Name or State of Organization

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7.74-1 Borrower identification information; nonconsumer transaction; changes in name or state of organization

6. Borrower Identification Information; Nonconsumer Transaction; Changes in Name or State of Organization

6.1. Representations and Warranties. Borrower represents and warrants to Lender that:

6.1.1. Borrower is _ _[*an individual*/*an organization of the following type: e.g., limited liability company*]_ _**:**

[*Add one of the following alternatives*]

[*Alternative 1: If Borrower is an organization*]

Borrower is organized solely under the laws of the following jurisdiction: _ _[*the state of* _ _[*name*]_ _]_ _**.**

Borrower's organizational identification number is _ _[*number*/*Borrower has no organizational number*]_ _**.**

[*Add the following if Borrower is not a "registered organization" as defined in Com C §9102(a)(70)*]

Borrower has _ _[*only one place of business, which is located at* **_____**/*more than one place of business. Its chief executive office is located at* **_____**]_ _**.**

[*Alternative 2: If Borrower is an individual*]

Borrower's _ _[*only/principal*]_ _ **residence is located at _____.**

[*Continue*]

6.1.2. Borrower's full, correct, legal name

[*If appropriate, add*]

, as indicated on the public record of the jurisdiction of its organization, which shows Borrower to have been organized,

[*Continue*]

is: _ _[*name*]_ _

6.1.3. Borrower's mailing address for purposes of any financing statement filed in connection with this Agreement is: _ _[*address*]_ _**. This address, if different from the address for Borrower in paragraph 5.6.2, is not Borrower's address for notices under this Agreement.**

6.1.4. The Collateral is for business, commercial and/or investment use by Borrower, and does not include goods used or bought for use by Borrower primarily for personal, family, or household purposes. The Obligations are incurred by Borrower for business, commercial and/or investment purposes, and not primarily for personal, family, or household purposes. The transaction that is the subject of the Loan Documents is not a consumer-goods transaction or a consumer transaction.

6.2. Changes in Name or State of Organization. Borrower will make no change to its name, organizational

status or existence, state of organization, or location without providing Lender _ _[*e.g., 30*]_ _ days' prior written notice.

Comment: In Paragraphs 6.1.1-6.1.3, to be completed as appropriate, the debtor is required to represent and warrant to the secured party all of the information regarding the debtor that must appear in the financing statement (see §7.31), and information relevant to determining the proper place to file the financing statement (see §7.34).

In Paragraph 6.1.4, the debtor represents and warrants to the secured party that this is not a consumer transaction. See Com C §9628(c).

In Paragraph 6.2, the debtor promises to notify the secured party before changing its name, organizational status, state of organization, or location. This promise, *if* timely performed by the debtor, alerts the secured party to the potential need to file a new or amended financing statement. See Com C §§9316(a), 9507(b)-(c), 9508; and §§7.32, 7.34. However, to safeguard the perfected status of its security interest, the careful lender will also make independent efforts to monitor the continuing accuracy of the information.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.75 I. Form: Borrower's Signature

§7.75 I. Form: Borrower's Signature

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.47-7.79.

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

7.75-1 Borrower's signature

Date: _ _ _ _ _ _ _ _[*Name of limited liability company*]_ _**, a California limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title, e.g., managing member*]_ _

Comment: See Com C §9203(b)(3)(A), and discussion in §7.12 on debtor's authentication of the security agreement. This signature form is for a limited liability company. It should be suitably modified for other entities.

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J. Exhibits

§7.76 1. Real Property Description

Because the security agreement's description of personal property collateral is keyed to particular real property (see §7.49), it is essential that an adequate description of the real property be attached as Exhibit A. This exhibit should be identical to the description of real property used in the deed of trust.

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§7.77 2. Itemized Personal Property List

An optional itemized list of personal property will be attached only in the infrequent situation when particular property is to be itemized. This list may be attached as Exhibit B. See §7.51.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.78 V. FORM: STATUTORY FORM OF UCC1 FINANCING STATEMENT

§7.78 V. FORM: STATUTORY FORM OF UCC1 FINANCING STATEMENT

[redacted]

UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGEMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (1a or 1b) – do not abbreviate or combine names

1a. ORGANIZATION'S NAME

OR

1b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
1c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

[redacted] | ADD'L INFO RE ORGANIZATION DEBTOR | 1e. TYPE OF ORGANIZATION | 1f. JURISDICTION OF ORGANIZATION | 1g. ORGANIZATIONAL ID#, if any ☐ NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (2a or 2b) – do not abbreviate or combine names

2a. ORGANIZATION'S NAME

OR

2b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
2c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

[redacted] | ADD'L INFO RE ORGANIZATION DEBTOR | 2e. TYPE OF ORGANIZATION | 2f. JURISDICTION OF ORGANIZATION | 2g. ORGANIZATIONAL ID#, if any ☐ NONE

3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) – insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME

OR

3b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
3c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

4. This FINANCING STATEMENT covers the following collateral:

5. ALTERNATIVE DESIGNATION [if applicable]: ☐ LESSEE/LESSOR ☐ CONSIGNEE/CONSIGNOR ☐ BAILEE/BAILOR ☐ SELLER/BUYER ☐ AG. LIEN ☐ NON-UCC FILING

6. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable]

7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] ☐ All Debtors ☐ Debtor 1 ☐ Debtor 2

8. OPTIONAL FILER REFERENCE DATA

Print

Instructions for National UCC Financing Statement (Form UCC1)

Please type or laser-print this form. Be sure it is completely legible. Read all Instructions, especially Instruction 1; correct Debtor name is crucial. Follow Instructions completely.

Fill in form very carefully; mistakes may have important legal consequences. If you have questions, consult your attorney. The filing office cannot give legal advice.

Do not insert anything in the open space in the upper portion of this form; it is reserved for filing office use.

When properly completed, send Filing Office Copy, with required fee, to filing office. If you want an acknowledgment, complete item B and, if filing in a filing office that returns an acknowledgment copy furnished by filer, you may also send Acknowledgment Copy; otherwise detach. If you want to make a search request, complete item 7 (after reading Instruction 7 below) and send Search Report Copy, otherwise detach. Always detach Debtor and Secured Party Copies.

If you need to use attachments, use 8-1/2 X 11 inch sheets and put at the top of each sheet the name of the first Debtor, formatted exactly as it appears in item 1 of this form; you are encouraged to use Addendum (Form UCC1Ad).

A. To assist filing offices that might wish to communicate with filer, filer may provide information in item A. This item is optional.

B. Complete item B if you want an acknowledgment sent to you. If filing in a filing office that returns an acknowledgment copy furnished by filer, present simultaneously with this form a carbon or other copy of this form for use as an acknowledgment copy.

1. **Debtor name**: Enter only one Debtor name in item 1, an organization's name (1a) or an individual's name (1b). Enter Debtor's exact full legal name. Don't abbreviate.

1a. Organization Debtor. "Organization" means an entity having a legal identity separate from its owner. A partnership is an organization; a sole proprietorship is not an organization, even if it does business under a trade name. If Debtor is a partnership, enter exact full legal name of partnership; you need not enter names of partners as additional Debtors. If Debtor is a registered organization (e.g., corporation, limited partnership, limited liability company), it is advisable to examine Debtor's current filed charter documents to determine Debtor's correct name, organization type, and jurisdiction of organization.

1b. Individual Debtor. "Individual" means a natural person; this includes a sole proprietorship, whether or not operating under a trade name. Don't use prefixes (Mr., Mrs., Ms.). Use suffix box only for titles of lineage (Jr., Sr., III) and not for other suffixes or titles (e.g., M.D.). Use married woman's personal name (Mary Smith, not Mrs. John Smith). Enter individual Debtor's family name (surname) in Last Name box, first given name in First Name box, and all additional given names in Middle Name box.
For both organization and individual Debtors: Don't use Debtor's trade name, DBA, AKA, FKA, Division name, etc. in place of or combined with Debtor's legal name; you may add such other names as additional Debtors if you wish (but this is neither required nor recommended).

1c. An address is always required for the Debtor named in 1a or 1b.

1d. **This field has been removed pursuant to California Uniform Commercial Code, Section 9526.5.**

1e,f,g."Additional information re organization Debtor" is always required. Type of organization and jurisdiction of organization as well as Debtor's exact legal name can be determined from Debtor's current filed charter document. Organizational ID #, if any, is assigned by the agency where the charter document was filed; this is different from tax ID #; this should be entered preceded by the 2-character U.S. Postal identification of state of organization if one of the United States (e.g., CA12345, for a California corporation whose organizational ID # is 12345); if agency does not assign organizational ID #, check box in item 1g indicating "none."

Note: If Debtor is a trust or a trustee acting with respect to property held in trust, enter Debtor's name in item 1 and attach Addendum (Form UCC1Ad) and check appropriate box in item 17. If Debtor is a decedent's estate, enter name of deceased individual in item 1b and attach Addendum (Form UCC1Ad) and check appropriate box in item 17.If Debtor is a transmitting utility or this Financing Statement is filed in connection with a Manufactured-Home Transaction or a Public-Finance Transaction as defined in applicable Commercial Code, attach Addendum (Form UCC1Ad) and check appropriate box in item 18.

2. If an additional Debtor is included, complete item 2, determined and formatted per Instruction 1. To include further additional Debtors, or one or more additional Secured Parties, attach either Addendum (Form UCC1Ad) or other additional page(s), using correct name format. Follow Instruction 1 for determining and formatting additional names.

3. Enter information for Secured Party or Total Assignee, determined and formatted per Instruction 1. If there is more than one Secured Party, see Instruction 2. If there has been a total assignment of the Secured Party's interest prior to filing this form, you may either (1) enter Assignor S/P's name and address in item 3 and file an Amendment (Form UCC3) [see item 5 of that form]; or (2) enter Total Assignee's name and address in item 3 and, if you wish, also attaching Addendum (Form UCC1Ad) giving Assignor S/P's name and address in item 12.

4. Use item 4 to indicate the collateral covered by this Financing Statement. If space in item 4 is insufficient, put the entire collateral description or continuation of the collateral description on either Addendum (Form UCC1Ad) or other attached additional page(s).

5. If filer desires (at filer's option) to use titles of lessee and lessor, or consignee and consignor, or seller and buyer (in the case of accounts or chattel paper), or bailee and bailor instead of Debtor and Secured Party, check the appropriate box in item 5. If this is an agricultural lien (as defined in applicable Commercial Code) filing or is otherwise not a UCC security interest filing (e.g., a tax lien, judgment lien, etc.), check the appropriate box in item 5, complete items 1-7 as applicable and attach any other items required under other law.

6. If this Financing Statement is filed as a fixture filing or if the collateral consists of timber to be cut or as-extracted collateral, complete items 1-5, check the box in item 6, and complete the required information (items 13, 14 and/or 15) on Addendum (Form UCC1Ad).

7. This item is optional. Check appropriate box in item 7 to request Search Report(s) on all or some of the Debtors named in this Financing Statement. The Report will list all Financing Statements on file against the designated Debtor on the date of the Report, including this Financing Statement. There is an additional fee for each Report. If you have checked a box in item 7, file Search Report Copy together with Filing Officer Copy (and Acknowledgment Copy). Note: Not all states do searches and not all states will honor a search request made via this form; some states require a separate request form.

8. This item is optional and is for filer's use only. For filer's convenience of reference, filer may enter in item 8 any identifying information (e.g., Secured Party's loan number, law firm file number, Debtor's name or other identification, state in which form is being filed, etc.) that filer may find useful.

Comment: This is the statutory form of financing statement (Form UCC1), which the filing office may not refuse to

accept. Com C §9521(a). See §7.31. The same form (with additional required information) is used for fixture filings. See §7.40.

Item 4 on the form is for the description of collateral. If, as is common practice, the description to be used is the same as that in the security agreement (see §7.33), then the following sentence can be inserted in Item 4: "The collateral covered by this Financing Statement is described in the attached addendum." A form collateral description addendum follows, in §7.79. To obtain forms, contact the California Secretary of State. The address, phone number, and website are in the Directory.

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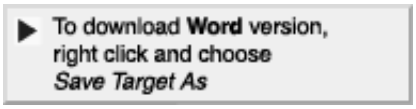
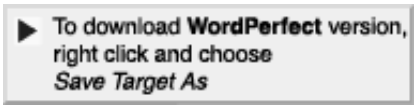
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.79 VI. FORM: COLLATERAL DESCRIPTION ADDENDUM TO FINANCING STATEMENT

§7.79 VI. FORM: COLLATERAL DESCRIPTION ADDENDUM TO FINANCING STATEMENT

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§7.47-7.79.





7.79-1 Collateral description addendum to financing statement

UCC FINANCING STATEMENT ADDENDUM

Name of First Debtor on Related Financing Statement:

_ _[*Name of First Debtor*]_ _, _ _[*an individual/a, e.g., limited liability company, corporation, limited partnership*]_ _

PART I

DESCRIPTION OF COLLATERAL

As used in this description of collateral:

(a) Borrower means the debtor named in this Financing Statement; and

(b) Real Property means the real property described in Part II of this Addendum, together with all of its present and future appurtenances, buildings, structures, improvements, and fixtures.

This Financing Statement covers all of the following property, now owned or hereafter acquired (collectively, the Collateral):

[*Insert the text of either Alternative 1 or 2 as set forth in the Security Agreement; see §7.49*]

_. Proceeds, Receipts, and Revenues. All proceeds, replacements, substitutions, products, accessions, and increases of any of the Collateral, and all receipts, revenues, rents, issues, and profits of operation, use, hiring, leasing, or licensing of any of the Collateral.

_. All Assets. All assets and all personal property of Borrower _ _[*relating in any way to the Real Property (including the ownership, design, development, construction, improvement, equipping, furnishing, use, leasing, operation, management, occupancy, financing or sale, damage, destruction, condemnation, or taking of the Real Property)*]_ _**.**

PART II

DESCRIPTION OF REAL PROPERTY

[*Insert description of real property identical to description in Security Agreement and Deed of Trust*]

Comment: The header shown at the top of this sample Addendum, which includes the title of the document ("UCC Financing Statement Addendum") and the name of the first debtor on the financing statement, must appear at the top of every page of the Addendum. There is a statutory financing statement addendum form (UCC1Ad) that can be used (Com C §9521(a)), but it has inadequate space for a lengthy collateral description.

Part I of the Addendum does two things: First, it sets out the entire description of collateral verbatim from the security agreement (either Alternative 1 or Alternative 2 in §7.49), including a proceeds description (see §7.50). Second, in a

concluding paragraph, the Addendum uses the "all assets"/"all personal property" formulation approved by Com C §9504(2) (see §7.31), and authorized by paragraph 3.10 of the security agreement (see §7.62). (The bracketed language in the final paragraph of Part I is discussed in the comment in §7.62.) As practice develops under revised Article 9, lenders in transactions with broad collateral coverage may well decide to forgo all but the "all assets"/"all personal property" formulation in the financing statement.

Part II of the Addendum contains a description of the real property that is identical to the description attached to the security agreement and the deed of trust. This description is essential, because the description of the collateral refers to it throughout the statement.

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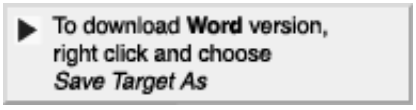
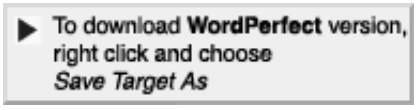
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/7 Taking and Perfecting a Security Interest in Personal Property Collateral Under Revised Commercial Code Division 9/§7.80 VII. FORM: DEPOSIT ACCOUNT CONTROL AGREEMENT

§7.80 VII. FORM: DEPOSIT ACCOUNT CONTROL AGREEMENT





7.80-1 Deposit account control agreement

DEPOSIT ACCOUNT CONTROL AGREEMENT

This Deposit Account Control Agreement (the Agreement) is made as of _ _[*date*]_ _, by and among _ _[*name of borrower*]_ _ (Borrower), _ _[*name of lender*]_ _ (Lender), and _ _[*name of bank holding deposit account*]_ _ (Bank).

Recitals

Borrower has granted a security interest to Lender in a deposit account of Borrower maintained at Bank, together with all funds now or in the future on deposit in, and all interest and other earnings on, the account (collectively, the Account).

The purpose of this Agreement is to provide Lender with control of, and to perfect Lender's security interest in, the Account.

Agreement

1. Information Regarding Account. Bank represents and warrants to Lender that (a) the Account has been established solely in the name of "_ _[*name of account holder*]_ _" at Bank's _ _[*location of branch*]_ _ branch, as Account No. _ _[*account number*]_ _; (b) the present balance in the Account is $_ _[*dollar amount*]_ _; (c) the Account is not represented by an instrument or any negotiable or nonnegotiable certificate of deposit; (d) Bank does not know of, and has not received any notice of, any asserted ownership, security, or other interest in or claim against the Account, other than the ownership interest of Borrower and the security interest of Lender; (e) Bank has not entered into any agreement, other than this Agreement and any account agreement with Borrower, for control of, compliance with instructions directing disposition of funds in, or otherwise relating to, the Account; and (f) Bank's records of the Account have been notated to reflect the existence of Lender's security interest in the Account and this Agreement.

2. Control; Compliance With Instructions.

2.1. Lender's Instructions. Bank will comply with all instructions originated by Lender directing disposition of funds in and otherwise relating to the Account without further consent of Borrower and without regard to any contrary instructions originated by Borrower.

[*Add one of the following alternatives*]

[*Alternative 1: Bank may not comply with Borrower's instructions*]

2.2. Borrower's Instructions. Unless otherwise notified in writing by Lender, Bank will not comply with any instructions originated by Borrower directing disposition of funds in or otherwise relating to the Account, but shall comply solely with instructions originated by Lender.

[*Alternative 2: Bank may comply with Borrower's instructions until Lender instructs otherwise*]

2.2. Borrower's Instructions. Despite the foregoing, unless Lender otherwise instructs Bank in writing, Bank may continue to comply with instructions originated by Borrower directing disposition of funds in or otherwise relating to the Account, except to the extent that any such instructions originated by Borrower are contrary to, or would prevent Bank from complying with, any instructions originated by Lender.

2.3. Third Party Instructions. Bank will not comply with or agree to comply with instructions originated by any third party directing disposition of funds in or otherwise relating to the Account, except as required by law.

3. Rights of Bank. Bank waives all of its present and any future rights against the Account, whether by way of setoff, banker's lien, security interest, or otherwise, except any rights of Bank against the Account with respect to (a) items deposited to the Account and returned unpaid; (b) overdrafts on the Account; and (c) the usual and customary Bank charges for maintenance of and routine services rendered with respect to the Account. Bank waives any right to require Lender to marshal assets or otherwise first seek to recover from security other than the Account for the obligations of Borrower.

4. Statements and Other Information; Notice of Claims.

4.1. Statements and Correspondence. Bank will provide Lender with copies of all statements and correspondence regarding the Account at the same time they are provided to Borrower, and by the same means of delivery, addressed to Lender in accordance with paragraph 7.2. Bank will provide Lender with such other information relating to the Account as Lender may reasonably request.

4.2. Notice of Claims Against Account. Bank will promptly notify Lender in writing if Bank knows of, or receives any notice of, any asserted ownership, security, or other interest in or claim against the Account other than the ownership interest of Borrower and the security interest of Lender.

5. Indemnity of Bank. Borrower will indemnify Bank and its officers, directors, employees, and agents against claims, liabilities, and expenses, including Bank's reasonable attorney fees, arising from this Agreement or Bank's compliance with this Agreement, except to the extent resulting from the gross negligence or willful misconduct of Bank.

6. Termination.

6.1 By Lender or Bank. Lender may terminate this Agreement at any time by written notice to Bank and Borrower. Bank may terminate this Agreement only on _ _[*e.g., 30*]_ _ days' prior written notice to Lender and Borrower. The provisions of paragraph 5 will survive any termination of this Agreement.

6.2 By Borrower. Borrower may not terminate this Agreement. Borrower's authorization of Lender to give instructions to Bank as provided in this Agreement is irrevocable and is coupled with an interest.

7. Notices.

7.1. Delivery of Written Notices. All notices contemplated under this Agreement will be given in writing and will be sent (a) for personal delivery by a delivery service that provides a record of the date of delivery, the individual to whom delivery was made, and the address where delivery was made; (b) by certified United States mail, postage prepaid, return receipt requested; or (c) by a nationally recognized overnight delivery service, marked for next-business-day delivery, with all charges prepaid or billed to sender's account.

7.2. Addresses for Notices. All notices will be addressed to the appropriate party at its address as follows or such other addresses as may be designated by notice given in compliance with this provision:

Bank: _____
_____
_____

Lender: _____
_____
_____

Borrower: _____
_____
_____

7.3. Effective Date of Notices. Notices will be deemed effective on the earliest of (a) actual receipt; (b) rejection of delivery; (c) if sent by certified mail, the third day on which regular United States mail delivery service is provided after the day of mailing; or (d) if sent by overnight delivery service, on the next day on which such service makes next-business-day deliveries after the day of sending.

8. Governing Law. This Agreement has been executed and delivered in and is to be construed, enforced, and governed according to the laws of the State of California, without regard to the principles of conflict of laws. The State of California is Bank's jurisdiction with respect to the Account for purposes of Section 9304 of the Uniform Commercial Code (and any similar or successor statute) as enacted in any state, despite any contrary provision in any other agreement between Bank and Borrower governing the Account.

9. Entire Agreement; Modification. This Agreement constitutes the entire understanding between Bank, Lender, and Borrower as to its subject matter and may not be modified or amended except by written agreement signed by all parties.

10. Partial Invalidity. If any provision of this Agreement is held to be invalid, illegal, unenforceable, or voidable in any respect, no other provision of this Agreement will be affected thereby, and such other provisions will remain binding and enforceable.

11. Parties Benefited. This Agreement applies to, inures to the benefit of, and binds all parties to this Agreement and their respective heirs, legatees, devisees, administrators, executors, successors, and assigns.

12. Headings. Headings are used for convenience of reference only and do not define or limit the scope of this Agreement.

13. Counterparts. This Agreement may be executed in counterparts, which together shall constitute the agreement of the parties and each of which shall be deemed an original.

LENDER:

Date: _ _ _ _ _ _

_ _[*Name of entity*]_ _,
a _ _[*specify entity, e.g., a California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

BORROWER:

Date: _ _ _ _ _ _

_ _[*Name of limited liability company*]_ _**, a California limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title, e.g., managing member*]_ _

BANK:

Date: _ _ _ _ _ _

_ _[*Name of entity*]_ _,
a _ _[*specify entity, e.g., a California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: A three-party control agreement such as this, entered into by the debtor, the secured party, and a bank holding a deposit account, is one of the means of achieving control perfection of a security interest in the account. Com C §9104(a)(2). See §7.29. This is a basic form of control agreement, and a bank may well require additional or different provisions. (For example, a bank may be unwilling to waive its rights as provided in Section 3, but it may be willing to

subordinate those rights to the secured party's security interest.) Banks are not required to enter into control agreements, even if requested to do so by a customer. Com C §9342.

This sample form is limited to a control agreement, and is not itself the document granting the security interest in the deposit account. Often, a security interest in a deposit account is reflected in a separate pledge agreement (see §7.7), even if (as is true of the sample security agreement in this chapter; see §7.49) the security agreement includes deposit accounts. When a pledge agreement is desired, the secured party may wish to consolidate the pledge agreement and the control agreement into a single document. But somewhere—in a security agreement, in a separate pledge agreement, in a combined deed of trust and security agreement, or in a combined pledge and control agreement—the debtor must *grant* a security interest in the deposit account.

There are two alternatives for paragraph 2.2. In some transactions, the secured party will require that it have sole control over a deposit account (Alternative 1). In other transactions, the secured party may allow the debtor to continue to have access to the account (Alternative 2). The latter approach does not defeat the secured party's control perfection of its security interest in a deposit account. Com C §9104(b).

Local law of a bank's jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in a deposit account maintained with that bank. Com C §9304(a). Commercial Code §9304(b) provides rules for determining a bank's jurisdiction for this purpose, and permits the bank and its customer to agree on a particular jurisdiction. The second sentence in Paragraph 8 of the deposit account control agreement is included for this purpose.

PRACTICE TIP: Obtaining a bank's consent to a form of a deposit account control agreement, and even identifying the appropriate person within the bank with the expertise and authority to negotiate and approve a control agreement, often involves some difficulty and delay. A bank typically has little incentive to participate in the process, other than fostering customer goodwill. Thus, when a deposit account with a third party bank will be part of the collateral, lender's counsel is well advised to commence this process early, and to inquire whether the bank has a particular form of control agreement which it requires or prefers. Of particular concern to the bank will be indemnity provisions in the agreement.

The American Bar Association's Business Law Section has established a Joint Task Force on Deposit Account Control Agreements, with the goal of creating various forms of deposit account control agreements acceptable to both commercial lenders and depository banks, with minimal negotiation. The Task Force has published its reports and several sample agreements and special-purpose inserts on its website (see ABA website in the Directory). See also *Initial Report of the Joint Task Force on Deposit Account Control Agreements,* 61 Bus Law 745 (Feb. 2006). If the Task Force's sample agreements gain recognition as being even-handed and authoritative, this should ease the process of obtaining control agreements.

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The Legal Opinion

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I. INTRODUCTION

§8.1 A. History of Opinion Letter

The third party legal opinion emerged from obscure origins to become a common feature of real property finance transactions. Those who have undertaken to trace its history have concluded that the legal opinion probably grew out of the practice dating back perhaps as far as the late 19th century of rendering opinions in corporate and municipal bond transactions and in the public and private placement of securities. Joint Committee of the Real Property Law Section of the State Bar of California and the Real Property Section of the Los Angeles County Bar, *Legal Opinions in California Real Estate Transactions*, 42 Bus Law 1139 (1987); Glazer, FitzGibbon, & Weise, Glazer and FitzGibbon on Legal Opinions: Drafting, Interpreting, and Supporting Closing Opinions in Business Transactions §1.1 at 1 (2d ed 2001) (referred to in the rest of this chapter as Glazer & FitzGibbon). For a compilation of reports on opinion letters, see Executive Committees of the Business Law and the Real Property Law Sections of the California State Bar, The 2002 California Opinion Reports, State Bar of California (2002); the publication is available to members on the State Bar website (see Directory). Despite its widespread use in the past half century, the third party legal opinion was the subject of few articles or books and even fewer judicial pronouncements until the 1970s. Today, the literature on opinions is considerable, although judicial pronouncements remain few in number. *Legal Opinions in California Real Estate Transactions*, 42 Bus Law at 1203, contains a bibliography of some of the more important works on legal opinions, many of which are the results of efforts by committees of state and national bar associations.

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§8.2 B. Scope of Chapter

In real property secured financing, the third party legal opinion takes the form of a letter from the borrower's lawyer addressed to the lender, covering a number of issues. The issues addressed in a typical legal opinion concern the due formation and continued existence of the borrowing and guaranteeing entities, their power and authority to enter into the loan transaction, the enforceability of the loan documents against those entities, and various other matters that call for a legal assessment of the impact of the loan transaction on certain aspects of the respective businesses of the borrower and guarantor. The movement toward standardization of the opinion letter, begun in the early 1990s, appears to have lost steam, and in its place there is a growing recognition that legal opinions are creatures of customary practice, evolving in response to changes in the law and the economy. Before addressing the issues covered by a typical real estate finance legal opinion (see §§8.28-8.75), this chapter will touch on the mixed results of the enfeebled standardization movement and the approaches to opinion practice that are taking its place (see §§8.3-8.5), the liability and ethical issues confronting the opinion giver (see §§8.6-8.13), and the process of negotiating (see §§8.14-8.16) and preparing (see §§8.6-8.27) an opinion letter. A form opinion is provided in §§8.76-8.90.

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§8.3 II. STANDARDIZATION VERSUS CUSTOMARY PRACTICE; DEFINITIONS

The movement toward creating a standard form of opinion reached its apex with the Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association, 47 Bus Law 167 (1991) (reprinted in 29 Real Prop Prob & Tr J 487 (1994)), which is composed of two parts: (1) a report on legal opinions and (2) an annotated opinion form (although, technically, only the annotated opinion is the "Accord," the authors will follow the common practice of referring to both the report and the annotated opinion as the ABA Accord). After that, a joint committee of the ABA Real Property, Probate & Trust Law Section and the American College of Real Estate Lawyers (ACREL) adapted the Accord to real estate loan transactions (Report on Adaptation of the Legal Opinion Accord of the Section of Business Law of the American Bar Association for Real Estate Secured Transactions of the Section of Real Property, Probate & Trust Law of the American Bar Association and the American College of Real Estate Lawyers, 29 Real Prop Prob & Tr J 569 (1994)) (ABA-ACREL Report), and a joint committee of the State Bar of California Real Property Section and the Los Angeles County Bar Association Real Property Section adapted the Accord to a California real property secured transaction (1995 California Real Property Legal Opinion Report by a Joint Committee of the Real Property Section of the State Bar of California and the Real Property Law Section of the Los Angeles County Bar Association (1995)) (California Report). In §§8.76-8.90 there is a form opinion, based on the ABA-ACREL opinion form and adapted to California practice, that follows the California joint committee recommendations. The form opinion is also annotated, with commentaries from ABA-ACREL, supplemented by the authors' comments. This chapter uses many of the defined terms from the Accord. Thus, the "opinion giver" is the attorney or law firm rendering the legal opinion, the "client" is the borrower or guarantor, and the "opinion recipient" is the lender.

The Accord, however, has not been well received, and the movement it led has given way to the belief that the legal opinion is the child of customary practice and ill suited to the strictures of a standard form. When it became clear that the Accord was not going to be the accepted "standard," promoters of the customary practice approach replaced the standard form with general principles or guidelines supposedly culled from the varied approaches of multitudes of opinion givers and recipients. See Section of Business Law of the American Bar Association, Committee on Legal Opinions, *Guidelines for the Preparation of Closing Opinions,* 57 Bus Law 875 (2002) (Business Law Section Guidelines) and *Legal Opinion Principles,* 53 Bus Law 831 (1998) (Opinion Principles), both of which cover opinions in general and form a part of the guidelines, published by the American College of Real Estate Lawyers Attorneys' Opinions Committee and the American Bar Association Section of Real Property, Probate and Trust Law, Committee on Legal Opinions in Real Estate Transactions, in *Real Estate Opinion Letter Guidelines*, 29 Real Prop Prob & Tr J 490 (2003) (ABA-ACREL Guidelines). The ABA-ACREL Guidelines and their relation to the Accord, the Business Law Section Guidelines, and the Opinion Principles are discussed more fully in §§8.5, 8.15, 8.21, 8.43.

Most recently the Legal Opinions Committee of the Section of Business Law of the American Bar Association adopted a *Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions,* 63 Bus Law 1277 (2008), which was approved by several bar and lawyer groups, including the Attorneys Opinion Committee of the American College of Real Estate Lawyers and the Legal Opinions in Real Estate Transactions Committee of the Real Property, Trust and Estate Law Section of the American Bar Association. The Customary Practice Statement noted that the "role of customary practice in third-party legal opinion practice is well established" and that "some closing opinions refer to the application of customary practice. Others do not. Either way, customary practice applies." 63 Bus Law at 1278.

The notion of customary practice is on its face antithetical to standardization of opinion forms and practice. Customs and practices change, and in a large state and a large country, the changes are not always uniform. The Customary Practice Statement does not suggest otherwise; rather, in its description of what an opinion may express or imply, it recognizes that there are elements of an opinion, both stated and unstated, whose meaning is understood by giver and recipient or is not required to be stated because the giver and recipient understand that certain unstated "assumptions, limitations, and standards of diligence" are understood to apply. 63 Bus Law at 1277. The Special Joint Committee of the Section of Business Law and the Section of Real Property, Planning and Zoning of the Maryland State Bar Association, 2007 Report on Lawyers' Opinions in Business Transactions (Maryland State Bar Ass'n 2007) (the report can be found at the website listed in the Directory) includes a host of assumptions and qualifications that are implied in an opinion and not required to be stated. The Customary Practice Statement also expressly recognizes that the understanding of due diligence, stated items, and unstated items may vary depending on the relevant jurisdiction that is the subject of the opinion. An opinion recipient in a state other than California must have some knowledge of customary

practice in California in order to understand the parameters of the opinion. However, with the various national bar associations and other professional organizations weighing in on customary practice, as well as the specifics of opinion elements, uniform understanding of the meaning of an opinion (as opposed to a uniform format) may be closer than it has been in the past.

Although those who write about opinions and prepare opinion reports have historically had little patience for the sometimes volatile characteristics of custom, urging instead the uniform adoption of the particular views on opinions that they espouse, the adoption of the Customary Practice Statement indicates a willingness to slowly move toward a common national understanding of a variety of practices. Perhaps the most revealing example of the "accept my viewpoint" approach comes in a 2007 report of the California State Bar, updating its 2004 report, on third party remedies opinions. After extolling the virtues of the concept of "customary practice" as a guiding principle in opinion practice, the report calls for the adoption of a "uniform national customary practice" for the remedies opinion. See State Bar of California Business Law Section, Report on Third-Party Remedies Opinions at 7 (2007 Update) (California 2007 Remedies Report), available online at the State Bar's website (see Directory). A customary practice that is uniform and national is not a customary practice, but a standardized practice in the spirit of the Accord. On the other hand, a customary understanding of the various iterations of a remedies opinion may be within the realm of possibility.

Advocates of "customary practice" use their favorite phrase to refer to several aspects of opinion practice. According to Glazer & FitzGibbon §9.1.2 n25: 2006 Cum Supp 103, "customary practice" plays a role in interpreting opinions, which they call "customary usage," in prescribing the work required to support opinions, which they call "customary diligence," and in indicating the skill and experience that opinion givers are expected to possess, which they call "customary competence." In criticizing the use of the term "customary practice" in discussing the propriety of the remedies opinion described in the original opinion report updated by the California 2007 Remedies Report, Glazer and FitzGibbon argue that customary practice "does not determine the circumstances in which particular opinions should or should not be requested." Adhering to the fiction that "customary practice" has something to do with the collective actions of those who give and receive opinions, Glazer and FitzGibbon equate customary practice with the "market," when they note that if customary practice were to determine when a particular opinion is appropriate, it would be equivalent to the market making that determination, an approach that the ABA Guidelines reject (see ABA-ACREL Guidelines §1.6). For Glazer and FitzGibbon, as for the authors of the California 2007 Remedies Report, whether an opinion recipient's counsel should ask for a particular opinion, and whether the opinion giver should have to give it, turns not on customary practice, or the market, but on a cost-benefit analysis. Each of these concepts seems to be encompassed within the Customary Practice Statement, which states that "[c]ustomary practice reflects a realistic assessment of the nature and scope of the opinions being given and the difficulty and extent of the work required to support them."

It is questionable whether the ABA-ACREL Guidelines equate customary practice with the market because they condemn the view that the market determines whether a specific opinion is appropriate, while holding that customary practice, and not cost-benefit analysis, determines "matters usually addressed in opinion letters." See ABA-ACREL Guidelines §1.6; see also ABA-ACREL Guidelines, App A, §I.B. As discussed in §8.5, the authors of opinion literature —not the market and not an empirical study of the practices among opinion recipients and opinion givers—determine customary practice. Just as it is impractical to conduct an empirical study of opinion practice to determine what is the market or what is customary practice on a particular opinion issue, it is impractical to expect lawyers jostling over whether an opinion issue should be decided one way or another to conduct a cost-benefit analysis of any worth on the subject. A good example is the flat statement made by the California 2007 Remedies Report that in many transactions the benefits of the remedies opinion do not justify their cost. See §8.15. In this era of word processing and e-mails, it is questionable whether the remedies opinion is costly to prepare or to negotiate, although other opinions requested, such as a land use opinion, might be. Cost-benefit analyses, perhaps especially those performed by lawyers, almost always yield debatable results. In the absence of case law, the reasoned arguments of opinion literature are the customary practice, the market, and the source of cost-benefit analysis. The Customary Practice Statement does not suggest otherwise, as it adheres to the view of the Restatement (Third) of the Law Governing Lawyers that "bar association reports on opinion practice [are] valuable sources of guidance on customary practice." *Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions,* 63 Bus Law 1277, 1278 (2008).

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§8.4 A. Reasons for Authors' Use of ABA-ACREL Form

Neither the ABA-ACREL form nor the Accord is in wide use in California, or anywhere else for that matter. Lack of acceptance of the Accord is attributable both to its unwieldy format and to the strong objections on the part of some lenders' lawyers—especially concerning the Accord's limitations on the due diligence expected of the opinion giver. See Robin & Pollock, *An Approach to Opinion Letters—The Silverado Accord and Other Model Forms From a Recipient's Perspective*, 29 Real Prop, Prob & Trust J 611 (1994). It is striking that the very provisions that some found objectionable in the Accord have enjoyed the widest acceptance in California opinion practice, including its definition of knowledge (see §8.20).

Despite the misgivings of some toward the Accord form, and the ABA-ACREL form in particular, and of others toward the notion of a standardized form in general, the authors have included a form in this chapter to (1) illustrate the points discussed in the text of this chapter, (2) provide a checklist for the preparation not only of a legal opinion but of an opinion request, and (3) permit the reader to avoid having to reinvent the proverbial wheel, by providing sample language that others have used to cover common issues and concerns.

The authors have selected the ABA-ACREL form for three reasons: First, any form that could be cobbled together from the variety of opinions issued by large and small California firms would either look remarkably like the ABA-ACREL form or would generate at least as many objections from lawyers on both the giving and receiving ends as the ABA-ACREL form does. Second, the ABA-ACREL form, like any other form promoted by state and national bar associations during the heyday of the standardization movement, is the distillation of the wisdom of lawyers who have devoted the most thought to issues raised by third party legal opinions. Third, as the embodiment of many of the principles set out in the ABA-ACREL Guidelines, the ABA-ACREL form represents the most current effort to articulate guidelines and principles that are (or should be) applicable to legal opinions rendered in real estate finance transactions.

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§8.5 B. "Universally Authoritative" Principles and Guidelines

In their introduction to the Accord, the authors noted lawyers' reluctance to follow bar association reports on legal opinions "because of uncertainty as to whether lawyers could rely on their conclusions as universally authoritative." 29 Real Prop, Prob, and Trust J 487, 489 (Fall 1994). According to these authors, this is the reason that opinion givers often include assumptions, limitations, and exceptions in their opinion letters that the bar reports concluded were unnecessary because they were inherent in the opinions being given. With the Accord, there would be no uncertainty about the meaning of typical opinions, and there would be no need to set out common assumptions, limitations, and exceptions. The Accord would serve as a standard form, an all-inclusive contract that would become part of every legal opinion that incorporates its terms by reference. According to its authors, the Accord does not "purport, in all respects, to reflect current opinion practice, nor does it purport to govern opinion practice with respect to opinions that do not expressly adopt it." The principles embodied in the Accord—which set limits on the due diligence of the opinion giver and on what a particular opinion does or does not imply, and which interpret common opinion formulations—derive their authority from the express adoption of the principles by the opinion giver and the tacit acceptance of the principles by the opinion recipient.

Unable to attain widespread acceptance of the Accord's format, the Business Law Section of the American Bar Association adopted the Opinion Principles in 1998 and Business Law Section Guidelines in 2001 (see §8.3), both of which purported to be expressions of customary practice. The ABA-ACREL Guidelines adopt and amplify the Business Law Section Guidelines and include the Opinion Principles as an appendix. Like the Business Law Section Guidelines and the Opinion Principles, the ABA-ACREL Guidelines state that they are applicable to all third party legal opinions. In other words, these three publications claim to be "universally authoritative," which is what the authors of the Accord said many lawyers felt the state bar reports were not. Most recently the Customary Practice Statement was approved by many national, state, and local bar associations. These organizations are listed in *Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions,* 63 Bus Law 1277 (2008).

What is the basis for the authority of these publications? Presumably, it is that these publications by the American Bar Association and the American College of Real Estate Lawyers contain principles derived from "customary practice." In Section 1.7, the ABA-ACREL Guidelines attempt to make its guidelines and principles into a bilateral contract between opinion giver and opinion recipient—an accord without the necessity of express incorporation—when it asserts that "[a]n opinion giver is entitled to assume, without so stating, that in relying on a closing opinion the opinion recipient (alone or with its counsel) is familiar with customary practice concerning the preparation and interpretation of closing opinions."

Just as the courts use the custom and practice of contracting parties to interpret their contracts, the courts should use the "customary practice" of lawyers engaged in rendering and accepting legal opinions as the basis for determining what the opinion givers and opinion recipients intended or understood the legal opinions to say, or for the establishment of judicial guidelines on the degree of due diligence the opinion giver was to undertake before rendering the opinion. If lawyers are assured that the courts will use these publications to understand the meaning and scope of legal opinions, lawyers will look upon the publications in a manner different from the way in which they looked upon the state bar reports of the past. The problem is that there have been very few reported decisions on legal opinions, and only one, *Dean Foods Co. v Pappathanasi* (Mass Super Ct, Dec. 3, 2004, 01-2595 BLS) 18 Mass L Rep 598, 2004 Mass Super Lexis 571, 2004 WL 3019442, discusses the role of opinion reports in molding the understanding of opinion givers and opinion recipients about the legal opinions they have given and received. The judge in the *Dean Foods* case, discussed in §8.7, reportedly referred to the 1998 Tri-Bar Report, appearing in *Third-Party "Closing" Opinions: A Report of the Tri-Bar Opinion Committee*, 53 Bus Law 591 (1998) as the "'bible' of opinion giving." Glazer & FitzGibbon §1.6.1, 23 n10: 2006 Cum Supp 17.

The ABA-ACREL Guidelines, like the state bar reports that preceded them, have certainly influenced opinion letter practice because the principles they articulate resonate with practitioners and because they strike a reasonable compromise between the conflicting needs of the parties involved. In this chapter, the authors will often refer to the ABA-ACREL Guidelines as an expression of what has become customary practice.

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§8.6 III. LIABILITY; MITIGATION; ETHICS

In negotiating and preparing the legal opinion, the opinion giver must at least have some familiarity with the grounds on which an attorney or a law firm may be held liable to an opinion recipient, as well as an understanding of the effect of the opinion on the relationship between the opinion giver and its client. With this knowledge, the opinion giver can craft opinion letters that address common opinion requests and serve as checklists for issues that arise in a typical transaction. The risk of liability has prompted most law firms to devise procedures for the review of an opinion letter by lawyers in the firm not involved in the transaction for which the opinion is being rendered. The impact of the third party opinion on client relations not only is a matter of risk mitigation, but also has ethical and practical implications. See §§8.7-8.13.

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§8.7 A. Theories of Liability

Both practical and theoretical issues confront the courts when they consider whether and in what circumstances an opinion recipient may hold an opinion giver liable. Because no attorney-client relationship exists between the opinion giver and the opinion recipient, any obligation of the giver to the recipient does not arise from a contract between them. Indeed, the opinion giver's engagement is with his or her client, a party adverse to the opinion recipient and to whom the giver owes an undivided duty of loyalty. Nonetheless, in delivering the legal opinion to the opinion recipient, the opinion giver intends to induce the recipient to rely on the statements in the opinion. The role of the legal opinion in facilitating the consummation of a transaction would vanish if the opinion giver were able to deliver an erroneous opinion with impunity. Recognizing this practical problem, the courts in California, and in most other jurisdictions, have constructed several theoretical foundations on which the opinion giver may be held liable to the opinion recipient for an erroneous opinion. Whatever the theory of liability, it has been observed, though with little empirical evidence other than three reported cases, that "[t]he frequency of suits involving third-party closing opinions has increased dramatically since… 2001.… Many of the actions are being brought by corporations and financial institutions that are represented by major law firms and that have the financial resources to pursue even the most demanding cases." Glazer & FitzGibbon §1.6.3, 27: 2006 Cum Supp 23.

In the absence of a contract between the opinion giver and the opinion recipient, the recipient may hold the giver liable for an erroneous opinion under four main theories: (1) negligence or legal malpractice, (2) third party beneficiary, (3) negligent misrepresentation, and (4) fraud. The discussion in §§8.8-8.11 is confined to the first three theories of liability. Actual fraud, of course, poses few practical or theoretical problems for the courts and commentators. A law firm that makes affirmative statements must not suppress information that is known to the firm, or at least to those participating in the transaction, and that makes the affirmative statements misleading. The affirmative statements may be in the form of an opinion, but need not be. Thus, in *Vega v Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 17 CR3d 26, the court held that a firm could be held liable for fraud because it had failed to reveal information in a schedule to a merger agreement that it had prepared for its client. The *Vega* case makes clear, however, that in the absence of an affirmative statement, the firm would have had no disclosure obligation.

The *Vega* case, when read with *Roberts v Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 128 CR 901 and the Massachusetts case of *Dean Foods Co. v Pappathanasi* (Mass Super Ct, Dec. 3, 2004, 01-2595 BLS) 18 Mass L Rep 598, 2004 Mass Super Lexis 571, 2004 WL 3019442, bolsters the argument in support of legal opinion practice. All three cases hold that a law firm has a duty to exercise reasonable care in disclosing information to a nonclient only if it makes an affirmative statement that is misleading in the absence of information that the law firm possesses but does not disclose. A prudent lender will therefore ask for an opinion to insure that it receives the benefits of a duty from the borrower's law firm that it would not otherwise enjoy, *i.e.*, the disclosure of information that the firm would otherwise have no duty to disclose.

Vega, Ball Hunt, and *Dean Foods,* when read together, hint that if a firm renders a legal opinion, it may be held liable to the opinion recipient if it acted unreasonably in determining that it need not disclose certain information. Lawyers are often confronted with the issue of whether to disclose certain information in an opinion or in a schedule. For example, should the firm disclose a regulatory agency inquiry that has been dormant for six months or a lawsuit against the client that the firm feels has little chance of success, but would perhaps have grave consequences if it succeeds? Fraudulent intent in suppressing information is not required to establish liability for misleading statements in an opinion letter. *Dean Foods* stands for the proposition that a firm may be liable if it is unreasonable in its determination that a particular piece of information need not be disclosed (in that case, a regulatory agency inquiry had been dormant for several months at the time the opinion was issued).

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§8.8 1. Negligence or Legal Malpractice

The courts have struggled with the application of negligence theory, or legal malpractice, in the legal opinion context because an element of negligence is the duty of care. How can an attorney, who owes an undivided duty of loyalty to a client, be liable for legal malpractice to a party adverse to the client? If the opinion giver owes a duty of care to the opinion recipient, the scope of that duty cannot be as broad as that owed by the opinion giver to the client. If the duty of care of the opinion giver were the same for both client and opinion recipient, the duty of loyalty owed by the giver to the client would surely be compromised. For example, a duty of care that is broad in scope might compel the opinion giver to point out to the opinion recipient any drafting errors in the transaction documents (unrelated to enforceability) that favor the client, a result not required by current opinion practice. A stark example would be a deed of trust that lacks a power of sale. Although deficient, the deed of trust without a power of sale is still enforceable as a mortgage. If the duty of care is not the same for the opinion recipient as it is for the client, the courts must somehow define the scope of the opinion giver's duty of care to the recipient, keeping in mind both the conventions of opinion practice and the tensions in the three-way relationship of opinion giver, client, and opinion recipient. See *Roberts v Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 128 CR 901. See also §8.13.

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§8.9 2. Third Party Beneficiary

The third party beneficiary theory permits the courts to limit the scope of the opinion giver's duty to the conventions of opinion practice. Those conventions are simply part of the contract to which the opinion recipient is a beneficiary. The third party beneficiary theory also permits the courts to reconcile the tensions in the three-party relationship that is at the base of the legal opinion. It is the client, in its engagement with its attorney, the opinion giver, who requests the giver to render the opinion letter to the opinion recipient, and the recipient is the intended beneficiary of that request. The weakness of the third party beneficiary theory is that this is not what is actually occurring. In practice, the opinion giver issues the legal opinion directly to the opinion recipient; it is not a contract between the opinion giver's client and the giver to which the recipient is the intended beneficiary. Generally, nothing in the agreements between the opinion giver and the client could be said to create rights for the opinion recipient as a third party beneficiary. The third party beneficiary theory neatly addresses the problems posed by negligence theory, but not without a dose of intellectual sleight of hand. See *Shannon v Superior Court* (1990) 217 CA3d 986, 266 CR 242; *Roberts v Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 128 CR 901; Restatement (Second) of Conflict of Laws §205, Comment d (1971).

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§8.10 3. Negligent Misrepresentation

Negligent misrepresentation substitutes notions of reliance on the part of the opinion recipient and intent by the opinion giver to cause the recipient to take action in reliance on the opinion for the notion of duty of care. In issuing the legal opinion, the opinion giver clearly intends the opinion recipient to take action; *i.e.,* making the loan to the client. In making the loan to the client, the opinion recipient appears to be relying on the statements made in the legal opinion, because the recipient generally conditions the making of the loan on the receipt of the legal opinion. Although overcoming the limitations of duty of care, negligent misrepresentation theory fails to address the issues posed by the duty of loyalty owed by the opinion giver to the client. It is for this reason that the court in *B.L.M. v Sabo & Deitsch* (1997) 55 CA4th 823, 839, 64 CR2d 335, made the sweeping statement that a law firm could not be held liable on a theory of negligent misrepresentation for opinions of law, but it could be held liable for negligent misrepresentation of fact. The *B.L.M.* case, however, dealt with an opinion rendered by the law firm to its own client, and the issue was whether a third party, who relied on that opinion, could hold the firm liable. The court may well have found the firm liable to the third party if the opinion had been rendered directly to the third party at the client's request. See *Bily v Arthur Young & Co.* (1992) 3 C4th 370, 11 CR2d 51; *Roberts v Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 128 CR 901.

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§8.11 4. Reliance

Whatever the theoretical basis may be for liability (see §§8.8-8.10), California courts are likely to hold an opinion giver who has issued an erroneous legal opinion liable to the opinion recipient. The erroneous opinion may be of law or of fact. In either instance, the opinion recipient must in fact have relied on the opinion in taking the action it took, and its reliance must be reasonable. For example, a California opinion recipient represented by California counsel may have difficulty establishing reasonable reliance on an opinion of law, such as an enforceability opinion rendered by a California opinion giver. Such an opinion recipient may have difficulty establishing that it relied on the opinion giver rather than on its own counsel. This is the argument made in California 2007 Remedies Report, at 6, when arguing against the common practice of requiring remedies opinions. An opinion recipient with out-of-state counsel, by contrast, has a more credible case for reliance on an opinion on California law rendered by a California opinion giver. See *Anderson v Deloitte & Touche* (1997) 56 CA4th 1468, 66 CR2d 512; *Roberts v Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 128 CR 901.

In considering whether to request or issue a particular opinion, reliance is a central issue. If the opinion assumes all facts to reach a narrow conclusion, as in a typical perfection opinion, or if the opinion is a mere conduit of the certification of the client or a government agency, as in a typical good standing opinion, the question arises why the opinion should be given in the first place. If the response is that the opinion giver should be willing to render the opinion because it cannot possibly result in liability, the question arises whether a court would share this perspective. Surely, the opinion recipient seeking damages will take the position that the court should interpret the opinion letter to give it a meaning that is not circular or merely a conduit for another document. Opinion givers should fear a court's construction of an opinion that gives it meaning when its author intended the opinion to be circular or a mere conduit. The fear is that the meaning given by a court will be consistent with the understanding of the lay opinion recipient, and not with that of the opinion recipient's more sophisticated and jaded counsel.

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§8.12 B. Risk Mitigation

The lack of reported cases holding lawyers and law firms liable on their opinions does not mean that the risk of liability is nonexistent, nor has the paucity of cases had any influence on the perception of risk among practitioners. Opinion literature and the lore among lawyers are filled with warnings about the risks in rendering opinions and the time-consuming process necessary to mitigate those risks. It is the perception of risk that has prompted most large law firms, and many midsized and smaller firms, to adopt formal procedures for the issuance of legal opinions in the name of the firm. The perception of risk is also perhaps responsible, at least in part, for the efforts by state and national bar associations to come up with definitive guidelines about the preparation and interpretation of legal opinions. The courts, too, need guidance on just what the parties intended by a particular opinion and just how much due diligence the opinion recipient expected the opinion giver to undertake before rendering the opinion.

Risk-mitigation procedures generally entail a review of the opinion by a member of the firm who is not involved in the transaction. The reviewer should be someone who keeps abreast of opinion practice and has specialized knowledge of the legal issues covered in the opinion. The reviewer is charged with the task of upholding the firm's policy, if there is one, on the form and types of opinions that the firm is willing or unwilling to issue, and to assist in articulating those reasons to counsel for the opinion recipient. Whenever possible, firms seek objectivity by requiring that the reviewers be uninvolved in the transaction and involved as little as possible with the client, to ensure that decisions relating to opinions not fall victim to firm economics and the ever-present client pressure to close. It may be appropriate to submit for review opinion issues requiring special expertise to attorneys with such expertise. The reviewer may also be part of a so-called opinion committee that develops the firm's response to common opinion requests, prepares the form opinions for the firm (sometimes with annotations), confronts difficult opinion requests, and formulates an approach for the firm in responding to such requests.

Small firms and sole practitioners may not have the resources for an opinion review by a neutral third party, to say nothing of lawyers who have the time to keep up with the esoterica of opinion practice and literature. For sole practitioners and members of small firms, the reports and especially the annotated forms published by state bars, the ABA, and American College of Real Estate Lawyers are invaluable references in dealing with the requests of an opinion recipient's counsel and the pressure of an important client to close the financing as soon and efficiently as possible. Practitioners who lack the support of opinion committees and opinion reviewers should be familiar with common opinion requests, and should enlist, when necessary, the aid of lawyers outside the firm to render opinions requiring a specialist's knowledge and experience.

Counsel for opinion recipients should be aware of the opinion giver's limitations. An opinion that fulfills the opinion recipient's wildest dreams may be worth little if it is apparent to counsel for the recipient that no one, least of all someone with little experience in the area of law being opined on, could render such an unrealistic opinion. As noted in §8.15, an opinion recipient cannot reasonably rely on an opinion that the recipient's own counsel finds wanting.

NOTE: The judge in *Dean Foods* (see §8.7) has been quoted as saying, "the opinion giver's failure to follow its written procedures for issuing opinions colored his decision and, more generally, that a law firm's inattention to its procedures for issuing opinions not only would 'not look good to a jury' but could turn out to be 'the rope' by which the firm hung itself." Glazer & FitzGibbon §1.6.2, 26 n19: 2006 Cum Supp 22.

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§8.13 C. Ethics and Clients

The legal opinion is at odds with the fundamental ethical principles that govern the attorney-client relationship. An attorney owes the client an undivided duty of loyalty and must act zealously in safeguarding the client's interests; but in the legal opinion, the opinion giver discloses information about the client to an adverse party, and vouches to the adverse party for the enforceability of the loan documents against the client. Usually, the negotiation of the legal opinion occurs on the eve of the transaction closing, which the client has been anxiously awaiting. The opinion giver all too often is in the position of having to weigh the risks of rendering a particular opinion against the interests of the client in bringing the loan transaction to a timely close. If a dispute involving a matter covered by the opinion arises after the closing, the opinion giver may be unable to provide undivided loyalty to and zealous representation of the client, because the legal opinion conflicts with the position the client desires to take in the dispute with the lender/opinion recipient. The client may thus find itself deprived of the services of the opinion giver, the attorney most intimately involved in the transaction.

The ethical considerations that the opinion giver must consider in rendering a third party legal opinion are set out in the ABA Model Rules of Prof Cond 2.3. The California Code of Professional Conduct does not address the third party legal opinion. The Model Rules describe the legal opinion as an "Evaluation for use by Third Persons." Under Rule 2.3, the opinion giver may render a legal opinion to other than a client if (1) the opinion giver reasonably believes that the rendering of the legal opinion is "compatible with other aspects of the lawyer's relationship with the client," and (2) the client consents to the opinion giver's rendering the legal opinion "after consultation."

The ABA Model Rules hint at a process for obtaining client consent that does not always occur in practice. Many practitioners infer the client's consent from the client's execution of loan documents or a loan commitment that requires the delivery of an opinion letter as a condition to closing the loan. With sophisticated clients for whom the third party legal opinion is a familiar aspect of the client's business, the implied consent and the absence of a detailed consultation may suffice. With less experienced clients, the opinion giver should explain to the client the meaning and implications of the legal opinion.

Some sophisticated lenders and their counsel now require evidence that the client has authorized the legal opinion, even if the evidence is only a statement in the opinion itself that the client has consented to the opinion. If the opinion involves disputed issues of law that may later become the focus of a dispute between the client and the opinion recipient, as is certainly possible in the real property secured finance arena, the opinion giver may have to explain the implications of rendering the opinion to even the most sophisticated client.

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§8.14 IV. NEGOTIATING THE LEGAL OPINION

It was the hope of those advocating standardization of the opinion format (see §§8.3-8.5) that an agreed-on format would soften disputes over the propriety of an opinion request, the wording of an opinion, or a qualification to an opinion, but even the most ardent supporter of standardization recognized that it would not eliminate negotiation over the form and content of opinions.

With the failure of the Accord's approach toward opinion standardization to gain widespread acceptance, treatise writers and bar committees have sought to identify alternative sources of authority for their pronouncements about legal opinions, their content, and their meaning. As noted in §§8.3 and 8.5, for those writing on opinions in the early years of the new millennium, custom and practice (or customary practice) is the source for guidance on the propriety of opinion requests, the format and meaning of opinion provisions, and the due diligence to be performed by the opinion giver. The comments to §§51(2) and 95 of the Restatement (Third) of the Law Governing Lawyers, which deal with third party legal opinions and the grounds for the opinion giver's liability to the opinion recipient, refer to customary practice as part of the relevant circumstances for ascertaining the construction of the third party opinion and the scope of the opinion giver's due diligence. See Comment e to §51 and Comments a and e to §95. Also, as noted in §§8.3-8.5, the term "customary practice" is a somewhat less than descriptive phrase for opinion literature, which has become the principal source of the analysis for defending or attacking a particular opinion request. Commentators and bar reports are also a source for guidance on the practicalities of negotiating the opinion amidst the flurry of activity leading to the closing of a transaction and the client's pressure to avoid the cost and delay of a dispute. As the Restatement recognizes in its discussion of the scope of due diligence for a third party opinion, "[c]ustom and practice… is articulated in bar-association reports, treatises and articles." See Comment a to §95. For the judge in *Dean Foods* (see §8.7), if customary practice were something other than the observations and reasoned opinions found in opinion literature, the "'bible' of opinion giving" would have been something other than the 1998 Tri-Bar Report—a piece of opinion literature, to be sure, but not an empirical study of opinion practice. See §8.5.

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§8.15 A. Opinion Request: The Golden Rule and Other Principles

As a starting point in analyzing whether a particular issue is a proper subject for an opinion request, most writers resort to the Golden Rule of opinion practice. See ABA-ACREL Guidelines §3.1. The Golden Rule is simple: Counsel should not request any opinion that he or she would be unwilling to give. As a corollary, counsel should not reject a qualification to an opinion that he or she would include in a similar circumstance. In addition, the commentators and bar reports have attempted to construct a rationale for the third party legal opinion and to use the rationale as a guide to resolving opinion disputes.

In practice, the Golden Rule plays a rather small role in resolving a dispute over an opinion issue, except in rare cases in which the opinion giver knows the practice of the law firm that is requesting the opinion. Invoking the purpose of the legal opinion in a dispute about the propriety of an opinion request is often a more effective means of arriving at a resolution. Under the ABA-ACREL Guidelines (see §8.5), the proper purpose of the third party legal opinion is to assist the opinion recipient in its diligence. ABA-ACREL Guidelines §1.1. This does not mean that the opinion giver is guaranteeing the transaction or providing financial support for the representations and warranties of the borrower or guarantor. As a lawyer, the opinion giver has a special expertise in exercising professional judgment about the application of law to discrete facts. Thus, according to the Opinion Principles appended to the ABA-ACREL Guidelines, "[t]he opinions contained in an opinion letter are expressions of professional judgment regarding the legal matters addressed and not guarantees that a court will reach any particular result." See ABA-ACREL Guidelines, App A, §I.D.

Despite the repeated assertion that the legal opinion should contain only expressions of professional judgment, it has become conventional to request, and to give, legal opinions requiring neither legal analysis nor the application of legal judgment. The commentators criticize requests for opinions based solely on a borrower's certification or a certificate or other document issued by a government authority. Opinions of this type, like the "good standing opinion" found in virtually every loan opinion, bear the opprobrious title of "conduit opinions." ABA-ACREL Guidelines §1.5.b (which even criticizes the very common "good standing opinion"). Opinion requests that call for a description of a rule or procedure, but no exercise of judgment, have also been the object of disapproval by commentators. An opinion on the perfection of security interests in personal property by means of filing a financing statement is just one example of an opinion that describes the law but does little else.

Counsel for opinion recipients continue to request, and opinion givers continue to give, opinions that require no legal analysis or judgment. This trend has not improved despite the proliferation of literature questioning whether the statements being requested are in fact legal opinions. There appears to be little resistance to such opinion requests because the opinion giver's statements are unlikely to give rise to liability. With no risk of liability, an opinion giver may yield to the opinion request rather than spend precious time and client resources arguing that the opinion is senseless, lacks content, or cannot be relied on by the opinion recipient because it involves neither a legal analysis nor a legal judgment. Such arguments are all too often fruitless because the response is not an argument about the value of the opinion but rather a flat statement that the opinion recipient, or its counsel, has received such statements from other law firms, or even from the opinion giver in a prior transaction. Opinions of little or no value have become conventional because the cost of resisting them, in terms of both money and time, is not justified by the risk of liability to the opinion giver. The growth of this questionable custom can only have a deleterious effect on the estimation in which practitioners hold third party legal opinions.

EXAMPLE: A lender may request a perfection opinion under the revised Division 9 of the California Uniform Commercial Code, when the borrower is organized in another state (*e.g.,* Delaware), and the place of perfection by filing under Division 9 is that of the other state. Though a California lawyer cannot give such an opinion as a legal opinion unless licensed to practice in the relevant state, such opinions are requested and given, but not apparently as legal opinions. Why are they requested and given? Because such opinions are easy to give and pose little risk of liability to the opinion giver. See §§8.74-8.74A.

The Business Law Section of the California State Bar has launched an attack against the common practice (which is not to be confused with the "customary practice") of requiring a remedies opinion when an opinion is rendered in a transaction. See California 2007 Remedies Report, cited in §8.3. The *Report* opens with the assertion that "[t]oo much time, effort and money are expended on third-party legal opinions. The main contributor to this excess is the remedies opinion." The *Report* goes on to argue that remedies opinions should only be requested in circumstances when opinion recipients are actually relying on the opinion, or in a complex or unusually structured transaction, opinion recipients and

their counsel will receive comfort that the opinion giver has a view of the transaction that is in harmony with their own view. *Report* at p 9.

NOTE: In an age of computers and the Internet, it is questionable whether a remedies opinion in fact consumes as much time and money as the *Report* asserts. This has not been the experience of this chapter's authors, in their capacities either as opinion givers or as counsel for opinion recipients.

The *Report*'s view of the purpose of the remedies opinion is also too narrow. It assumes that the remedies opinion is of no use in a transaction unless the opinion recipient relies on it. Like other opinion literature, the *Report* fails to take into account the role the opinion plays in structuring a transaction and bringing to light early on problems and issues that might otherwise spring to life on the eve of a closing, or haunt the transaction parties after the deal is done. The mere prospect of having to render an opinion focuses the opinion giver on aspects of a transaction that the opinion giver might otherwise ignore. Usury is one example. If a syndicate of lenders is making a loan, and one of the lenders is from out of state, the law firm facing the prospect of rendering a remedies opinion might well point out the usury issue early in the transaction, permitting the participants in the transaction ample opportunity to work around the issue. It is difficult to establish empirically how often this focusing function of the opinion letter has yielded practical results. In fact, many opinion recipients choose to accept whatever assumption or qualification is provided rather than go through the drill of restructuring a transaction, particularly if the issue is adequately articulated. It is, however, certain (in the opinion of this chapter's authors) that the elimination of the custom and practice of requiring a remedies opinion will certainly dim the focus of the erstwhile opinion giver, increasing the cost of some transactions.

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§8.16 B. Negotiating the Legal Opinion: Timing and Client Concerns

The press of due diligence and document preparation and negotiation often means that lawyers for both the borrower and the lender postpone until the last minute any discussion of the form and content of the opinion. This is too often the case despite the fact that all are aware from the outset of the transaction that the lender and its counsel will be requiring an opinion. The opinion literature universally laments the custom of postponing dialogue on opinion issues, urging that counsel take up these issues as early as possible in the transaction.

Lenders and sophisticated borrowers generally have experience with opinion letters and have some understanding of the role they play and the issues they raise. Less sophisticated borrowers and inexperienced lenders often look on the opinion as something for the lawyers to handle or a checklist item, no more significant than the escrow instructions or any other item needed to close. Lawyers negotiating legal opinions must therefore be aware of the degree to which their clients would appreciate the subtle arguments that often characterize discussions about the propriety of a particular opinion request or the wording of an opinion response or exception or qualification, especially when the dispute over the request or the wording threatens to delay or even derail a transaction. For the lawyers on both sides of the table, it is better that lender's counsel apprise borrower's counsel at the outset of the transaction on what issues the opinion should cover, and that borrower's counsel promptly notify lender's counsel if there is a problem with any of the requests. ABA-ACREL Guidelines §2.1.

Being aware of the benefits of putting opinion issues on the table early, lenders and their counsel often make the form of an opinion a part of the first draft of the loan documents.

PRACTICE TIP: Lender's counsel should provide a form or a bullet point list of opinion requirements geared to customary practice early in the transaction. Such planning will help borrower's counsel in providing a timely response and lead to early resolution of disputes.

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§8.17 V. DUE DILIGENCE: DOCUMENT REVIEW, FACTUAL ASSUMPTIONS, AND DEFINING KNOWLEDGE

Facts are central to legal opinions. Most opinions involve the application of legal judgment to facts. Some involve representations of facts themselves. The opinion giver must either ascertain the truth of the facts on which legal conclusions in the opinion letter are based or assume that the facts are true. Because lawyers are rarely in a position to directly verify the facts about their clients, they must rely on client certificates or certificates from third parties (such as government agencies or other professionals such as architects), or they must make express assumptions about the existence of facts that form the basis of their conclusions of law. In an opinion letter, the purely factual opinion about a client or its business is generally couched in terms of the knowledge of the opinion giver. In addition to assumptions and a knowledge qualification, the opinion letter often contains further express limitations on the degree of due diligence conducted by the opinion giver in matters of both law and fact. ABA-ACREL Guidelines, App A, §III.

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§8.18 A. Justifiable Reliance

If the opinion giver relies on certificates or assumptions in rendering an opinion, the reliance must be justifiable or "warranted," to use the terminology of the Accord. This term simply means that the opinion giver may not assume facts that the opinion giver knows to be untrue. In the words of §5 of the Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association, 47 Bus Law 167 (1991) (reprinted in 29 Real Prop Prob & Tr J 487 (1994):

> *Unwarranted Reliance*. As a general and overarching principle, the Opinion Giver may not rely on information (including certificates or other documentation) or assumptions, otherwise appropriate in the circumstances, if the Opinion Giver has Actual Knowledge that the information or assumptions are false or the Opinion Giver has Actual Knowledge of facts that under the circumstances would make the reliance unreasonable.

If the opinion giver knows information that makes the factual assumptions or certifications untrue, the giver may not rely on the information unless the giver and the opinion recipient agree to the contrary. Such an agreement may come in the form of a statement in the legal opinion expressly noting that the opinion giver is assuming or relying on information that is or may be untrue. If the opinion giver does not know that the factual assumptions or certifications are untrue, but knows other information that would reasonably raise a question about their accuracy, the issue arises whether the giver must further investigate the information. As may be expected, there is no clear answer, it being a matter of judgment that depends on the facts of the given case. If the opinion giver conducts no further investigation because the cost or other factors make the investigation unreasonable in the circumstances, the giver may want to consider stating expressly that no investigation was undertaken. For a thorough discussion of the relationship between knowledge and justifiable reliance, see *Dean Foods Co. v Pappathanasi* (Mass Super Ct, Dec. 3, 2004, 01-2595 BLS) 18 Mass L Rep 598, 2004 Mass Super Lexis 571, 2004 WL 3019442, cited in §8.7.

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§8.19 B. Knowledge as Limit to Due Diligence

In the excerpt from the Accord quoted in §8.18, the term "actual knowledge" appears. Certain opinions that are now commonplace in business transactions, including real property financing transactions, are essentially representations of fact about the client or its business. The no-litigation opinion (discussed in §§8.46-8.51) is an example. In the no-litigation opinion, the opinion giver is stating that he or she has no knowledge of any litigation against the client. Following the Accord, the ABA-ACREL Guidelines recognize that using the term "knowledge" in opinion practice is a means of limiting the due diligence conducted by the opinion giver. In qualifying the opinion to the opinion giver's knowledge, the giver is alerting the opinion recipient that it has conducted at best a limited investigation into the facts on which the opinion is based. ABA-ACREL Guidelines §§3.3a, 3.4, and 3.4a.

In its definition of "opinion giver's actual knowledge," the Accord describes the kind of investigation undertaken by the opinion giver. The Accord does not actually use its definition of knowledge in any of the opinions it covers. It assumes that all factual inquiries on which the opinion giver bases its opinions are to the giver's actual knowledge, or to be more accurate, it assumes that whatever the giver is relying on, be it a certificate or an assumption, is not contradicted by facts actually known to the giver. The effect of the Accord perspective is to permit the opinion giver to render opinions without investigation of facts, as long as the facts on which the opinions are based are not contrary to what is actually known to the giver and certain others. This is regardless of whether the facts are contained in an assumption or are expressly stated (as with a no-litigation opinion). The Accord position is reflected in the ABA-ACREL Guidelines.

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§8.20 C. Accord's Definition of Knowledge

The Accord is not widely used in opinion practice, but its definition of "knowledge" is. The Accord defines "opinion giver's actual knowledge" as "the conscious awareness of facts or other information by the Primary Lawyer or the Primary Lawyer Group." In the Commentary to its definition of knowledge, the Accord makes clear that an opinion giver need not examine all its files relating to the client or canvas every lawyer in the giver's firm who may have worked for the client. These Accord principles, as well as the Accord definition of knowledge, are found in the ABA-ACREL Guidelines.

As defined in the Accord, the "primary lawyer group" consists of individuals involved in the transaction and those who prepare the opinion. Some firms have further limited the "primary lawyer group" to those involved in the transaction who are at the firm at the time the transaction closes, to take into account persons who have left the firm during the course of the transaction and are not available to be questioned when the opinion is being finalized. Under the Accord and the ABA-ACREL Guidelines, the primary lawyer group is charged only with the facts and the information of which it is consciously aware at the time the opinion giver renders the opinion.

According to the Accord Commentary, the definition of "actual knowledge" as conscious awareness is intended to negate any requirement that the primary lawyer group undertake extensive investigation of facts contained in certificates or assumptions, and to recognize that the members of the primary lawyer group may have forgotten facts at the time the opinion is rendered of which they were previously aware.

NOTE: Opinion givers often qualify opinions (or confirmations) such as the no-litigation or no breach or default opinions with the phrase "to our knowledge." In the world of transactions where opinions are born, this phrase is limiting. In the world of litigation, where opinions are tested, at least one litigator has questioned whether a jury would understand a phrase that is commonly used to express knowledge as expressing the total absence of knowledge. For the lay juror, "to my knowledge" means I know facts, even if it is only facts that establish the absence of something. Glazer & FitzGibbon §4.4, 127 n20: 2006 Cum Supp 70.

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§8.21 D. Assumptions and Disclaimers

The Accord contains a litany of common assumptions, which are reproduced in the form opinion at §8.79. The Accord takes the position that common assumptions need not be stated in an opinion that incorporates the Accord by reference. The Opinion Principles attached to the ABA-ACREL Guidelines (see §8.5) state that assumptions of general application that apply regardless of the type of transaction or the nature of the parties need not be expressly stated in the opinion, presumably as a matter of customary practice. See ABA-ACREL Guidelines, App A, §III.D.

Assumptions may be of law or of fact, or a combination of the two. The opinion giver may have to make additional assumptions, depending on the nature of the transaction and the role played by the giver. For example, an opinion giver rendering a local counsel opinion that focuses on the enforceability of a deed of trust under California law may have to assume the entity status and capacity of the borrower, the due authorization, execution, and delivery of the loan documents, including the deed of trust, and perhaps even the enforceability of the note and other secured obligations.

The opinion literature has taken aim at a practice that lenders' counsel frequently engages in: requesting that the opinion giver state that it has no knowledge of any facts that would make untrue the factual assumptions on which the opinion giver is expressly relying. ABA-ACREL Guidelines §4.4. Of special concern is the requirement of such an assurance in connection with an opinion giver's assumption of the accuracy of its client's certificate or of representations, warranties, and schedules in the loan documents. Glazer & FitzGibbon §18.8: 2006 Cum Supp 344. The opinion literature rightly characterizes these assurances as negative assurances.

The assurance appears to be nothing more than a statement of what the opinion literature, from the Accord to the ABA-ACREL Guidelines, requires of opinion givers. Glazer & FitzGibbon §18.8 n3: 2006 Cum Supp 344. If an opinion giver may not rely on an assumption if it knows facts that make the assumption untrue, then why is it objectionable to require the opinion giver to state that it knows no such facts? Glazer and FitzGibbon call such a seemingly innocuous assurance a "wolf in sheep's clothing," which poses inherent risks of an unspecified nature that "have become more apparent" to opinion preparers and which "arguably" places the opinion giver "in a position of… guaranteeing the accuracy of their client's factual representations." Glazer & FitzGibbon §18.8: 2006 Cum Supp 344. It is apparently the *Dean Foods* case that has made apparent the risks of this negative assurance, for the law firm in that case included it twice in its opinion, and the judge latched on to that fact in his opinion. Glazer & FitzGibbon §18.8 n4: 2006 Cum Supp 344. It should be recalled that the law firm in *Dean Foods* (see §8.7) knew the facts that undermined the assumptions it made and the opinions it gave. Liability was arguably justified in that case even in the absence of the negative assurance. Nonetheless, an explicit statement that one has no knowledge of facts seems to pose risks, or at least to imbue opinion givers with the fear of risks, that are either not present, or not perceived to be present, with the implicit assurance that props up every opinion. Perhaps the risk is that a trier of fact will latch on to the express statement, which it cannot do with the implied statement, "arguably" putting the opinion giver in the position of guarantying factual representations of its client. Though included in the ABA-ACREL all-inclusive opinion and form 8.79-1, the authors do not believe that, in most cases, the negative assurance is appropriate.

Disclaimers are also frequently used to limit opinions. Such disclaimers include the disclaimer of any obligation to update the opinion after the date of the opinion letter and the disclaimer of any opinions other than those stated in the opinion letter. Under the ABA-ACREL Guidelines, both of these disclaimers are principles that underlie opinion practice and therefore need not be stated.

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E. Qualifications

§8.22 1. Generic Qualifications

In addition to assumptions, the legal opinion generally contains qualifications and limitations that further define the scope of the opinion giver's undertaking in rendering the opinion. Common limitations, each of which is found in the opinion letter form in §§8.76-8.90, state the laws of the jurisdiction or jurisdictions for which the opinion giver is rendering its opinions and identify the person or persons who may rely on the opinion letter.

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2. California Qualifications

§8.23 a. List of Customary Qualifications

In a California real property finance transaction, the opinion giver qualifies its opinions on the enforceability of provisions that run counter to specific provisions of California law. Thus the opinion giver renders no opinion that loan document provisions are valid that:

(1) Require the borrower to carry hazard insurance in excess of the replacement value. Civil Code §2955.5 prohibits such requirements and provides that a violation of the statute does not affect the validity of the loan but does give rise to causes of action in the borrower's favor for both injunctive relief and damages, including reasonable attorney fees and costs. See Paragraph 3.6.1 in form 8.84-1.

(2) Require impound accounts. Numerous statutes regulate and restrict the manner in which impound accounts may be required in connection with an indebtedness secured by an interest in real property. CC §§2954-2954.2, 2954.8, 2955. See Paragraph 3.6.2 in form 8.84-1.

(3) Permit the lender to use insurance or condemnation proceeds to reduce the debt, absent a showing that to do otherwise would result in impairment of the lender's security or that the lender's security is in fact impaired. See *Schoolcraft v Ross* (1978) 81 CA3d 75, 146 CR 57; *Milstein v Security Pac. Nat'l Bank* (1972) 27 CA3d 482, 103 CR 16. See Paragraph 3.6.3 in form 8.84-1.

(4) Permit the lender to enforce an assignment of rents other than as allowed by law or permit the lender to collect rents without applying them to the debt. See Paragraph 3.6.4 in form 8.84-1. On assignment-of-rents provisions and the need for qualification, see §8.24.

(5) Purport to insulate the lender from becoming a mortgagee-in-possession despite the lender's collecting rents or taking other actions that might be construed as taking possession. See Paragraph 3.6.5 in form 8.84-1.

(6) Waive the borrower's reinstatement or redemption rights. The debtor may cure a monetary default and "reinstate" the debt, despite provisions in the loan documents permitting the lender to accelerate the maturity date of the loan on a default by the debtor. CC §2924c. See Paragraph 3.6.6 in form 8.84-1.

(7) Conflict with laws governing foreclosure or limitations on fees. Code of Civil Procedure §726 describes the procedures for a judicial foreclosure, and CC §§2924-2924*l* describe the procedures for a nonjudicial foreclosure. The amount of attorney fees and trustee fees recoverable by a creditor in a judicial or nonjudicial foreclosure may be limited. See CC §2924d. Division 9 of the California Commercial Code contains provisions governing the foreclosure of personal property collateral. See Com C §§9601-9629. See Paragraph 3.6.7 in form 8.84-1.

(8) Indemnify a party against its own negligence or willful misconduct. See Paragraph 3.6.8 in form 8.84-1. For further discussion of indemnification, see §8.25.

(9) Conflict with antideficiency, fair value, and one-action rules. See Paragraphs 6-8 and 10-11 in this section. See Paragraph 3.6.9 in form 8.84-1. See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5 (4th ed Cal CEB 2009).

(10) Accelerate the debt on transfer except as permitted by law. Before passage of the Garn-St. Germain Depository Institutions Act of 1982 (Pub L 97-320, 96 Stat 1469 (1982)) (codified in various sections throughout Titles 11, 12, 15, 20, and 42 of the United States Code), a lender in California could not accelerate the maturity date of its loan if the debtor conveyed the real property security, unless the lender could demonstrate that enforcement was reasonably necessary to protect against impairment of its security or that the transfer resulted in an increased risk of default. See *Wellenkamp v Bank of America* (1978) 21 C3d 943, 148 CR 379. The Garn Act preempted state law and permitted every creditor to enforce a provision accelerating the loan if the debtor conveyed the security. The Garn Act and the Regulations implementing it (12 CFR §§591.1-591.6) provide that, despite any provision of the constitution, laws, or judicial decisions of a state to the contrary, a lender may (with certain exceptions) enter into and enforce a "due-on-sale" clause. Often, however, "due-on-sale" clauses are drafted broadly to include not only sales, but encumbrances, and the term "encumbrance" may include, in addition to subordinate liens to secure indebtedness, other transfers of interests in the property, such as a lease or an easement. The Garn Act may not preempt state law with respect to encumbrances that are not liens securing indebtedness. If this is so, California law, not federal law, would govern whether a lender can accelerate a loan if the borrower places such an encumbrance on the real property security. See Paragraph 3.6.10 in form 8.84-1.

(11) Select any jurisdiction's laws to govern. On choice-of-law issues, see §§8.64-8.66; for a form of qualification, see Paragraph 3.6.11 in form 8.84-1.

(12) Provide for penalties, liquidated damages, late charges, default interest rate, and certain other additional costs. For further discussion, see Comment in §8.84; see Paragraph 3.6.12 in form 8.84-1.

(13) Purport to absolutely assign contracts, permits, licenses, etc. in connection with a loan transaction. It is likely that a court will enforce an assignment of intangible property not as an absolute assignment, but rather as an assignment for security. Additionally, it is uncertain that a UCC foreclosure of a security interest (see §4.40) in a property-related contract (such as a management or construction agreement) will be meaningful before completion of a foreclosure of a deed of trust on the real property to which the contract relates; further qualification regarding this would be appropriate. See Paragraph 3.6.19 in form 8.84-1.

For additional qualifications commonly given in California real property financing transactions, see Paragraphs 3.6.13-3.6.19 in form 8.84-1.

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§8.24 b. Assignment-of-Rents Qualification

The 1997 enactment of CC §2938 simplified the task of opining on the enforceability of the assignment-of-rents provision. The opinion can now simply state that every assignment of rents, whether absolute or for security, is enforceable in the manner prescribed by §2938. On enforcing such assignments, see chap 5. See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 6, 11 (4th ed Cal CEB 2009).

Loan documents continue to provide that the assignment of rents is an absolute assignment, and not an assignment for security, despite CC §2938(a), which provides that even an assignment of rents that on its face purports to be absolute, or absolute conditioned on default, creates only a security interest in the rents and leases. Lenders apparently still hope that §2938 has not eliminated the absolute assignment in California in the context of the secured lending transaction, or simply do not believe that an absolute assignment, even if legally nothing more than a security assignment, impairs their loan documentation. With an absolute assignment, the creditor theoretically "owns" the rents from the date of the assignment, although the debtor may have a license to collect until default occurs. *Malsman v Brandler* (1964) 230 CA2d 922, 41 CR 438. With a security assignment, the creditor has only a lien on the rents from the date of the assignment, which must be perfected or enforced before the lender is entitled to any rents. *In re Goco Realty Fund I* (Bankr ND Cal 1993) 151 BR 241, 248. The opinion on the enforceability of the assignment-of-rents provision should not be read as an opinion that that assignment will be enforced as an absolute assignment, as that term was used in *Malsman v Brandler, supra,* or that the parties intended the assignment to be absolute and not for security (despite the opinion convention that an enforceability opinion implies that the parties intended the characterization that they have placed on their agreements; see §§8.52-8.58). More thoughtful courts have always questioned whether the parties truly intended an assignment of rents in the context of a secured real property transaction to be absolute. See Williams, Hindmarsh, O'Neill & Waldman, *Assignment of Rents—The Next Generation*, 15 Cal Real Prop J 27 (Winter 1997); Geiger & Hindmarsh, *A Brief History of Rents: The Evolution of Assignments of Rents and Related Enforcement Procedures in California*, 7 Miller & Starr Real Estate Newsalert 5, 261 (May 1997). No opinion giver can be expected to opine, explicitly or implicitly, that a provision purporting to be an absolute assignment, no matter how strongly worded and unequivocal, will be enforced as a true absolute assignment. See also discussion in §8.72A.

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§8.25 c. Indemnification

The enforceability of a provision that indemnifies a party against its own negligence or willful misconduct is open to question. Although the courts will enforce a provision that clearly requires one party to indemnify another against the latter's own negligence, it is unclear how specific the clause must be to ensure enforcement. A clause "expressly and unequivocally" indemnifying a negligent party should be enforceable, but less explicit indemnification clauses will be applied only to instances of "passive negligence." *MacDonald & Kruse v San Jose Steel Co.* (1972) 29 CA3d 413, 105 CR 725. Indemnification for negligent or willful misconduct can be enforced if the parties have a clear and express indemnification agreement. *Goldman v Ecco-Phoenix Elec. Corp.* (1964) 62 C2d 40, 41 CR 73; *County of Alameda v Southern Pac. Co.* (1961) 55 C2d 479, 11 CR 751; *King v Timber Structures* (1966) 240 CA2d 178, 49 CR 414; *Baldwin Contracting Co. v Winston Steel Works* (1965) 236 CA2d 565, 46 CR 421.

It is likely, however, that courts will scrutinize such clauses carefully to ensure that the indemnification is sufficiently clear and freely given, thus making enforceability turn on factual issues that are arguably outside the proper scope of a legal opinion. Additionally, CC §2782 prohibits indemnification in construction contracts when the indemnified party's sole negligence or willful misconduct causes the loss or injury. The reach of §2782 also can be expanded to disputes incidental to construction contracts. See *Southern Pac. Transp. Co. v Sandyland Protective Ass'n* (1990) 224 CA3d 1494, 274 CR 626. The courts' willingness to broaden the reach of §2782 suggests that they may be reluctant to enforce all-encompassing indemnification clauses and may seek grounds to rule that such clauses are sometimes contrary to public policy.

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§8.26 F. Certificates

In opinion practice, "certificates" have become important vehicles for establishing facts not otherwise accessible to the opinion giver. Often, a certificate is from a government agency. The Accord calls such certificates "public authority documents." The opinion may be based solely on such documents. One example is the good standing opinion (discussed in §8.29). Requests for such opinions are often criticized because they entail none of the opinion giver's judgment and knowledge, which justifies the legal opinion in the first place. See the discussion of "Conduit Opinions" in ABA-ACREL Guidelines §1.5.b.

The certificate that the opinion giver obtains from its client should certify only facts; it should not certify conclusions of law.

EXAMPLE: The opinion giver cannot rely on the client's statement that no conflict exists between the loan documents and any other agreement to which the client is a party, although client certificates often contain such statements. The opinion giver may, however, rely on the client's statement that specified agreements are the only agreements (or material agreements) to which the client is a party; in this event, the language in the opinion should follow the language in the certificate.

It is up to the opinion giver to read the listed agreements to decide whether the execution of the loan documents or performance of the payment obligations under the loan documents would breach or cause a default under the listed agreements.

In executing the client's certificate, the client becomes involved, perhaps for the only time, in the opinion process. Although the opinion giver frequently prepares the client's certificate for signature in the heat of a closing, because only then are all the facts to be certified actually known, the opinion giver should avoid treating the client's certificate as simply one more loan document for the client to sign. The opinion giver should consider the implications of the certificate on the client. In so doing, the opinion giver should bear in mind the nature of the legal opinion and opinion process. Not only is the opinion giver asking for representations from his or her own client that often mirror the representations requested by the lender, the giver wants a responsible and knowledgeable individual representing the client to sign the certificate, in his or her individual capacity. The opinion giver may even find himself or herself making such a request after arguing forcefully against a similar request made by the lender. The client's certificate serves as a reminder that the legal opinion can (and sometimes does) place the opinion giver in a position of conflict with his or her own client.

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§8.27 VI. ANATOMY OF A LEGAL OPINION FOR A REAL ESTATE SECURED LOAN

The following is an outline of the various components of a typical legal opinion for a real estate secured transaction. Some of the components of a legal opinion, such as assumptions and qualifications, are discussed in §§8.21-8.25. Others are discussed further in §§8.28-8.75. Some Comments to the form opinion in §§8.76-8.90 make observations about certain of the components, which are not discussed elsewhere in this chapter.

- **Identity of opinion recipients.** The legal opinion is in the form of a letter to the lender or lenders. The legal opinion ends with a paragraph limiting who may rely on it. The Accord calls the persons to whom the legal opinion is addressed and the persons who may rely on the legal opinion the "opinion recipient." See form 8.89-1.
- **List of documents reviewed.** This list is rarely comprehensive. Its function is often to provide definitions for use in the opinions. The list is accompanied by a statement that the opinion giver has reviewed such other documents as he or she deems advisable to render the opinions. If the legal opinion is limited in scope, as, *e.g.,* with a local counsel opinion, the list of documents reviewed may limit the documents that the opinion giver has in fact reviewed. If so, the legal opinion should contain a statement to that effect. See form 8.77-1.
- **Assumptions, qualifications, and limitations.** These may be located in various places within the legal opinion. Common assumptions, qualifications, and limitations are (see form 8.79-1):
- **Regarding borrower:** If the legal opinion is a local counsel opinion and concerns only enforceability, the opinion giver may make assumptions about the borrower's existence, power, and authority. See §§8.29-8.41.
- **Regarding signatories:** Assumptions may be made as to the capacity of the signatories to the transaction documents. See Paragraphs 3.1.3-3.1.5 in form 8.79-1.

NOTE: As a matter of customary practice, an opinion giver has no obligation to verify the client's signature on loan documents. There is an implicit assumption in the legal opinion that the client's signature is genuine, and the opinion giver may rely on that assumption, unless he or she knows facts that would belie that assumption. Glazer & FitzGibbon §9.4: 2006 Cum Supp 125.

- **Regarding actions of parties:** Assumptions may be made about the execution and delivery of the transaction documents and entity actions taken to authorize the execution, delivery, and performance of the transaction documents and the transactions contemplated by them. These assumptions generally relate only to the opinion recipient. If the legal opinion is a local counsel opinion, however, the assumptions may also relate to the client (the borrower and guarantor).
- **Regarding documents reviewed:** Assumptions may be made about the relationship between the documents reviewed and those actually executed and delivered.
- **Regarding absence of other agreements:** An assumption is generally made that no other agreements or understandings modify the documents reviewed.
- **Regarding lender:** Assumptions are generally made that the loan documents are binding on the lender and that the lender has the power and authority to enter into the loan documents. If an opinion is being rendered that the loan documents do not violate California's usury laws (see Paragraph 2.7 in form 8.78-1), there is generally an assumption about the exempt status of the lender under such laws (see form 8.79-1, paragraph 3.1.19). An assumption may also be made that the lender is qualified to transact business in California to the extent required and, to the extent not otherwise exempt, is licensed to make the subject loan under the California Finance Lenders Law (Fin C §§22000-22780), (see form 8.79-1, paragraph 3.1.20). Some out-of-state lenders require an opinion that the lender need not qualify to do business in California solely because of the loan in question (see Paragraph 2.11 in form 8.78-1).
- **Regarding applicable law:** The legal opinion is limited to the laws of the jurisdiction in which the opinion giver is licensed. See Paragraph 1.3 in form 8.77-1. The opinion giver may also opine on the corporation and limited liability company laws of the state of Delaware and on federal law (other than such specialized statutes as the federal securities laws). See Report of the Tri-Bar Opinion Committee, *Third-Party Closing Opinions: Limited Liability Companies*, 61 Bus Law 679, 683 (2006).
- **Regarding reliance:** Reliance on the legal opinion is limited to opinion recipients and specified others (see §8.18; see form 8.89-1).
- **Exceptions to enforceability opinion.** For discussion, see §§8.56-8.57; for form, see, *e.g.,* §§8.81-8.82, 8.84.
- **Commonly requested opinions.** The following is a list of opinions commonly requested in real property secured

financing transactions:

- **Legal capacity** of individuals and signatories (for discussion, see §8.28 ; see Paragraph 2.1 in form 8.78-1).
- **Entity formation and status** (for discussion, see §§8.29-8.34; see Paragraph 2.1 in form 8.78-1).
- **Power and authority** and due authorization, execution, and delivery (for discussion, see §§8.35-8.41; see Paragraph 2.2 in form 8.78-1).
- **No-conflict opinions:**
- With organizational documents (for discussion, see §8.42; see Paragraph 2.8 in form 8.78-1).
- With laws (for discussion, see §8.43; see Paragraph 2.9 in form 8.78-1).
- With other contracts (for discussion, see §8.44; see Paragraph 2.8 in form 8.78-1).
- With court orders and decrees (for discussion, see §8.45; see Paragraph 2.8 in form 8.78-1).
- **No pending litigation** (for discussion, see §§8.46-8.51; see form 8.88-1).
- **Remedies or enforceability** (see §§8.52-8.55; see Paragraph 2.4 in form 8.78-1).
- **Reasoned opinions**. For discussion, see §8.59; for example, see Alternative 2 of Paragraph 3.9 in form 8.87-1.
- **Enforceability of a choice-of-law provision**. When a state other than California is chosen to govern enforceability of the loan documents (for discussion, see §§8.60-8.63; see form 8.87-1).
- **Specialized opinions.** The following is a list of specialized opinions:
- **Perfection.** For discussion, see §§8.68-8.70; see Paragraph 3.1.18 in form 8.79-1.
- **Title opinion.** This is almost never given by California lawyers.
- **Environmental and land use opinions.** (see §8.72).
- **Securities laws opinion.** These opinions are generally beyond the scope of opinions provided by real estate lawyers. They can, however, arise in a real estate setting, particularly involving the sale of vacation ownership interests combined with rental pool arrangements.
- **Bankruptcy opinions.** These include no fraudulent transfer, no preferential transfer, and, as may be required by lenders in large conduit loan transactions, substantive nonconsolidation (that the borrower's assets will not be considered as part of the bankruptcy of another person, such as a principal in the borrowing entity).

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VII. ISSUES COVERED IN TYPICAL REAL ESTATE FINANCING OPINION

§8.28 A. Legal Capacity of Individuals and Signatories

The focus of the third party legal opinion in a real estate secured financing is the enforceability or remedies opinion. To render this opinion, the opinion giver must verify that the borrower has entered into a set of loan documents that are binding on the borrower. If the borrower is an individual, the issue is whether the borrower has the capacity to execute the documents. An opinion giver generally assumes that the individual has the requisite legal capacity.

The issue of legal capacity of an individual borrower rarely concerns the opinion giver, because borrowers in real estate secured transactions are usually entities and not individuals. The issue, however, does arise if the secured loan is guaranteed because guarantors are often the holders of the equity in the borrowing entity, and those holders may be natural persons. In any event, lawyers are not in a position to determine whether their individual clients have the legal capacity to bind themselves to a contract, be it a note or a guaranty. An individual borrower's or guarantor's legal capacity is generally among the assumptions made by the opinion giver. See Commentary to Accord §4.

The capacity of the borrowing entity to bind itself to the loan documents is not an issue that the opinion recipient and its counsel will permit the opinion giver to assume away. A question arises whether, in executing the loan documents, the signatories of the borrower have the individual legal capacity (as opposed to entity authorization). The Accord's position is that a natural person's legal capacity is an issue that the opinion giver is entitled to assume, whether the individual is the client or is signing on the client's behalf. See Accord §4(a).

Although the borrowing entity's capacity to bind itself is a legal issue that borrower's counsel must resolve in order to render the enforceability or remedies opinion, the opinion request generally requires counsel to set out a series of opinions on which the remedies opinion is based. An opinion on an entity's capacity implies that the entity has been formed, continues to exist, and has the power and authority under its organizational documents to bind itself to the loan documents. In a typical request, the opinion giver is required to set out separate opinions on entity formation and existence (the entity formation and status opinion; see §§8.29-8.34 and for form see Paragraph 2.1 in form 8.78-1), and on power and authority (the power and authority opinion; see §§8.35-8.41 and Paragraph 2.2 in form 8.78-1).

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B. Entity Formation and Status Opinion

§8.29 1. Elements and Use

A typical entity formation and status opinion has three elements:

- A statement about the type of entity that the borrower or guarantor is (*e.g.,* "the borrower is a corporation");
- A statement about the manner in which the entity was formed (*e.g.,* "duly incorporated," "duly organized," or "duly formed"); and
- A statement about the entity's current status (*e.g.,* "and validly existing and in good standing").

If the borrower or guarantor does business in more than one jurisdiction, the opinion recipient may require an assurance that the entity is qualified to do business in the foreign jurisdiction.

The question arises as to why a lender needs an opinion about the borrower's entity status in a real estate secured transaction, or, for that matter, any other transaction. If the borrower turns out not to be the corporation, limited partnership, or limited liability company expected by the lender, the result is arguably beneficial to the lender. The shareholders, limited partners, or members may now be personally liable for the loan as general partners, which is the default status if entity formation requirements are not met. In a California real property secured transaction, however, this result may be of little use because of the effect of the antideficiency and one-action rules, CCP §§726, 580b, and 580d. In fact, if the shareholder, limited partner, or member is a guarantor of the loan, its liability as a general partner due to the entity's failure to meet formation requirements may work to the lender's detriment by giving the guarantor the argument that the guaranty itself is subject to California's one-action and deficiency limitations. See *Union Bank v Brummell* (1969) 269 CA2d 836, 75 CR 234. On one-action and antideficiency statutes, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5 (4th ed Cal CEB 2009).

Moreover, carelessness in the formation and maintenance of the borrower's entity status may indicate a lack of care in other borrower activities.

Although California lawyers should not be giving opinions about the laws of other states, it has become commonplace for law firms with a corporate practice to render entity formation and status opinions for corporations incorporated under the Delaware General Corporations Law. Some firms even render entity formation and status opinions for entities like limited liability companies and limited partnerships formed under the Delaware General Corporations Law.

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§8.30 2. Due Diligence, Entity Formation, and Status Opinion

In the discussion that follows on the due diligence required to render an entity formation and status opinion, the focus is on the requirements of California law. The entities covered are those that commonly hold real property in California:

- Corporations (see §8.31);
- Limited partnerships (see §8.32);
- Limited liability companies (see §8.33); and
- General partnerships (see §8.34).

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§8.31 a. Corporations

The documents necessary to support an entity formation and status opinion for a corporation are as follows:

(1) Articles of incorporation, certified by California Secretary of State. This document supports the opinion that the entity is "duly incorporated." A copy of an entity's articles certified by the California Secretary of State is conclusive evidence that the entity was formed as a corporation, except in a quo warranto action brought by the California Attorney General. Corp C §209. The certified articles, however, establish only prima facie evidence of the entity's continued existence as a corporation.

(2) Certificate of good standing issued by California Secretary of State. This document establishes that the entity "validly exists" and is "in good standing," *i.e.,* that its corporate charter has not been forfeited or suspended as of the date of the certificate. Suspension or forfeiture of a corporate charter may result if the entity fails to file a tax return or to pay taxes to the California Franchise Tax Board, or fails to file an annual statement with the California Secretary of State. The Secretary of State does not assure that the entity has paid all its taxes; it assures only that any failure to pay has not reached the level of suspension or forfeiture of the entity's corporate charter. For assurances regarding payment of taxes, the opinion giver should obtain a certificate from the Franchise Tax Board. See item (4) below.

It is customary for the opinion giver to state that, in giving an opinion on existence and good standing, the giver is relying solely on the certificate of good standing, which, if the certificate is dated reasonably close to the opinion's issuance date, is normally acceptable to the recipient. This practice has led to the argument that the good standing opinion has no more value than the certificate itself; that it is merely a conduit opinion and should therefore not be required. The standard response is that the good standing opinion is a part of "customary practice" at this point. Moreover, there is a marginal benefit to the opinion recipient for even the most conventional opinion requirement: At the very least, the opinion giver is impliedly stating that the giver has no knowledge of facts that would belie the statement being made in the certificate of good standing that the entity is indeed in good standing.

A certificate of good standing speaks only as of a certain date. It is important to order this certificate early because a timely response by the Secretary of State even to a "rush" letter is not assured. Timing gaps that arise have several solutions, the acceptability of which to either the opinion giver or the opinion recipient will depend on the circumstances:

- The opinion giver can obtain an oral date-down from the California Secretary of State on the date of the closing, which the Secretary will give to most attorneys' services;
- The opinion giver can obtain a recent date-down from the website of the California Secretary of State on the date of the closing (see Directory for website);
- The opinion giver can request a certificate from an officer of the entity that, to the officer's knowledge, the entity's charter has not been suspended or forfeited; or
- The opinion giver can do nothing further.

In the latter two instances, the opinion recipient may or may not find acceptable the opinion giver's relying solely on the good standing certificate in rendering the good standing opinion. It puts the risk on the recipient as to whether the company remains in good standing since the date of the certificate. If the opinion giver is relying on an officer's certificate, then the opinion recipient is as well. The risk is that the officer certifying that there has been no forfeiture or suspension of the corporate charter is either not telling the truth or does not have access to the required information.

(3) Minute book of the entity on commencement of dissolution proceedings. An examination of the minute book will establish whether the board of directors has commenced a voluntary dissolution of the corporation. More often, the opinion giver states in the borrower's certificate that the board of directors has not begun a voluntary dissolution.

(4) Certificate issued by Franchise Tax Board on taxes. The tax clearance certificate establishes that the entity has paid its taxes and filed its tax returns with the California Franchise Tax Board. Failure to pay taxes or file tax returns puts a corporation at risk of losing its charter or having its charter suspended. Rev & T C §23335. This certificate should be ordered early because it takes even longer to obtain than a certificate of good standing.

(5) Additional documents needed for due organization opinion. A duly incorporated corporation is not necessarily a duly organized corporation, at least according to the opinion reports and commentators. "Due organization" means that the initial bylaws have been adopted and the minimum number of directors and officers required by law and the charter documents have been elected. It also means that the board of directors of the

corporation has authorized the initial issuance of the corporation's capital stock. Thus, in addition to the corporate charter, the opinion giver must also obtain and examine the following documents to establish that the corporation is duly organized:

- **Initial bylaws.** These should be certified by an officer of the company as part of the officer's certificate (item (6) below).
- **Minute book.** This will confirm the election of officers and directors.
- **Stock ledger.** This will establish whether the corporation has issued stock and, if so, to whom. If the corporation is closely held, as corporations in real estate finance transactions often are, a lender may require the opinion giver to verify current shareholders of the corporation and the percentage held by each shareholder. The opinion giver may verify the ownership of stock by examining the stock ledger and the minute book and by obtaining a certificate from a corporate officer.

If the opinion giver was involved in the formation of the corporation, the due organization opinion should not be difficult to give, especially if the corporation was formed close to the date the opinion is being given. If the corporation was formed recently but by another firm, the opinion giver may still be able to render a "due organization" opinion because the task of cleaning up the corporate records may be a manageable one. If, however, the corporation was formed by another firm, or by the opinion giver many years earlier, the corporate due diligence and corporate cleanup required to issue the opinion may be costly and burdensome. Many firms refuse to issue due organization opinions for entities not formed by the firm, or formed many years earlier. (The New York Mortgage Loan Opinion Report has excluded the due organization opinion from its model opinion. See Association of the Bar of the City of New York, Committee on Real Property Law, Subcommittee on Mortgage Loan Opinions, and the New York State Bar Association, Real Property Law Section, Attorney Opinion Letters Committee, *Mortgage Loan Opinion Report*, 54 Bus Law 119 (1998) and 33 Real Prop Prob & Trial J 551 (1998) (New York Mortgage Loan Opinion Report).) Once again, the rationale for this position is that the opinion recipient should be concerned about whether the corporation exists and is in good standing at the time the opinion is rendered, not that the historical formation of the corporation conformed with the law many years earlier.

(6) Client certificate. In the context of formation and good standing opinions, the client certificate, signed by a corporate officer, verifies the conformity of the documents being examined by the opinion giver to the original documents (*e.g.,* bylaws, stock ledger, minute book) and supports factual elements of the opinions being given (*e.g.*, that no dissolution proceedings have been commenced by or against the corporation). Other supporting information may be found in the client certificate that goes beyond the entity formation and status opinions. On authorization, see §§8.37-8.38; on material agreements in no-breach or default opinion, see §8.44; on no-litigation opinion, see §§8.46-8.51.

(7) Certificate of status as a foreign corporation authorized to do business in California. If the corporate borrower encumbering California real estate in favor of an opinion recipient is organized in a state other than California, the opinion recipient usually requires an assurance that the entity is authorized to do business in California. This assurance can be established by filing a Statement and Designation by Foreign Corporation with the California Secretary of State, which may be certified by the California Secretary of State. A Certificate of Status may also be obtained from the California Secretary of State.

(8) Certificate of status of California corporations in other jurisdictions. If the issue is whether the California corporation is authorized to do business in a particular jurisdiction, the opinion giver must obtain a certificate comparable to a certificate of foreign qualification issued by the appropriate officer in the appropriate jurisdiction.

For a thorough discussion of organization of corporations, see Organizing Corporations in California (3d ed Cal CEB 2001).

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§8.32 b. Limited Partnerships

The documents necessary to support an entity formation and status opinion for a limited partnership are as follows:

(1) Certificate of limited partnership, certified by California Secretary of State. This document supports the opinion that the limited partnership is "duly formed." A copy of a certificate of limited partnership (the LP-1) certified by the California Secretary of State is conclusive evidence that the entity was formed as a limited partnership and is prima facie evidence of the entity's continued existence as a limited partnership. Corp C §15621(c) (Corp C §15902.01, operative Jan. 1, 2008, for new or electing limited partnerships). The opinion giver should also obtain all amendments to the certificate of limited partnership (the LP-2).

(2) Certificate of status issued by California Secretary of State. This document establishes that the limited partnership "validly exists" and is in "good standing." The good standing opinion for a limited partnership suffers from the same defect as a good standing opinion for a corporation: They are both conduit opinions, based solely on a certification of a government authority. The certificate of status of a limited partnership speaks only as of a certain date. As with a corporate certificate of good standing, the gap between the date of the certificate and the date of the legal opinion, if significant, should be handled in a manner acceptable to both opinion recipient and opinion giver. On these points, see the discussion of corporate certificates of good standing in item (2) of §8.31.

(3) Agreement of limited partnership. An examination of the agreement of limited partnership will reveal the circumstances, if any, under which the limited partnership will dissolve.

(4) Client certificate. In the context of formation and good standing opinions, a client certificate, signed by an individual general partner or an officer or managing member of an entity general partner, verifies the conformity of the documents being examined by the opinion giver to the original documents (*e.g.,* agreement of limited partnership) and supports factual elements of the opinions being given (*e.g.,* that no dissolution proceedings have been commenced by or against the limited partnership). Supporting information may also be found in the client certificate that goes beyond the entity formation and status opinions. On authorization, see §8.37; on material agreements in no-breach or default opinion, see §8.44; on no-litigation opinion, see §§8.46-8.51.

(5) Certificate of status as limited partnership authorized to do business in California. If the limited partnership borrower encumbering California real estate in favor of an opinion recipient was formed in a state other than California, the recipient generally requires an assurance that the entity is authorized to do business in California. This assurance can be established with an Application for Registration of Foreign Limited Partnership (LP-5) from the California Secretary of State, which may be certified by the California Secretary of State. A Certificate of Good Standing may also be issued by the California Secretary of State. Corp C §15693 (Corp C §15909.02, operative Jan. 1, 2008, for new or electing limited partnerships).

(6) Certificate of status in other jurisdictions of California limited partnerships. If the issue is whether the California limited partnership is authorized to do business in a particular foreign jurisdiction, the opinion giver must obtain a certificate comparable to certificate of foreign qualification issued by the appropriate officer in the appropriate jurisdiction.

On limited partnerships, see Advising California Partnerships (3d ed Cal CEB 1999).

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§8.33 c. Limited Liability Companies

The documents necessary to support an entity formation and status opinion for a limited liability company are as follows:

(1) Articles of organization, certified by California Secretary of State. This document supports the opinion that the limited liability company is "duly formed." A copy of the company's articles of organization certified by the Secretary of State is conclusive evidence that the entity was formed as a limited liability company and is prima facie evidence of its continued existence as such. Corp C §17050(c).

(2) Certificate of status issued by California Secretary of State. This document establishes that the limited liability company "validly exists" and is "in good standing." The good standing opinion for a limited liability company suffers from the same defect as a good standing opinion for a corporation: They are both conduit opinions, based solely on a certification of a government authority. The certificate of status of a limited liability company also speaks only as of a certain date. As with a corporate certificate of good standing, the gap between the date of the certificate and the date of the legal opinion, if significant, should be handled in a manner acceptable to both opinion recipient and opinion giver. On these points, see the discussion of corporate certificates of good standing in item (2) in §8.31. The Franchise Tax Board will also issue a tax certificate for a limited liability company. On tax certificates, see item (4) in §8.31.

(3) Operating agreement. An examination of the written operating agreement may reveal the circumstances, if any, under which the limited liability company will dissolve.

(4) Client certificate. In the context of formation and good standing opinions, the client certificate verifies the conformity of the documents being examined by the opinion giver to the original documents (*e.g.,* the operating agreement) and supports factual elements of the opinions being given (*e.g.,* that no dissolution proceedings have been commenced by or against the limited liability company). Supporting information may be found in the client certificate that goes beyond the entity formation and status opinions. On authorization, see §§8.37, 8.39; on material agreements in no-breach or default opinion, see §8.44; on no-litigation opinion, see §§8.46-8.51.

(5) Certificate of status as a limited liability company authorized to do business in California. If the limited liability company borrower was formed in a state other than California, the opinion recipient generally requires an assurance that the entity is authorized to do business in California. This assurance can be established with an Application for Registration as a Foreign Limited Liability Company (LLC-5) certificate of foreign qualification from the California Secretary of State, which may be certified by the California Secretary of State. A Certificate of Good Standing may also be obtained from the California Secretary of State. Corp C §15693.

(6) Certificate of status in other jurisdictions of California limited liability companies. If the issue is whether the California limited liability company is authorized to do business in a particular foreign jurisdiction, the opinion giver must obtain a certificate comparable to certificate of foreign qualification issued by the appropriate officer in the appropriate jurisdiction.

On organization of limited liability companies, see Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007).

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§8.34 d. General Partnerships

The documents necessary to support an entity formation and status opinion for a general partnership are as follows:

(1) General partnership agreement. This document establishes that the general partnership has been formed. With general partnerships, there are no issues of good standing or valid existence. The opinion giver must examine the general partnership agreement for any provisions for dissolution.

(2) Certificate of partners. A California Secretary of State Statement of Partnership Authority (GP-1) may be signed by all partners in the partnership to certify the accuracy and completeness of the general partnership agreement, the absence of any events causing the dissolution of the partnership, and the authorization of one or more partners to act on behalf of the partnership in the transaction. Corp C §16303. The opinion giver may request that all partners sign the certificate as one way in which the giver can be certain about the composition and terms of the partnership and the partnership agreement. Alternatively, the opinion recipient may decide to rely (or to permit the opinion giver to rely) on the certification of only one general partner, particularly a managing general partner, regarding the composition and terms of the partnership and partnership agreement. On authorization, see §§8.37, 8.41.

On general partnerships, see Advising California Partnerships (3d ed Cal CEB 1999).

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§8.35 C. Power and Authority

A contract is binding on an entity only if (1) the entity's organizational documents permit it to enter into the contract and to consummate the transactions contemplated by the contract, and (2) the representatives through which the entity acts are authorized to sign the contract on its behalf. Like the entity formation and status opinion, the power and authority opinion and the due authorization opinion are analytical components of the remedies or enforceability opinion. Nonetheless, it has become a convention in legal opinion practice to expressly set out opinions that the borrower or guarantor entity has power and authority to enter into the contract in question and that both the actions taken on the entity's behalf and those taking such actions are authorized by the governing body of the entity. Opinion recipients often request that the opinion giver expand the power and authority opinion to encompass not only the financing transaction, but also the ownership of the real property collateral and the conduct of the business of the borrower or guarantor.

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§8.36 1. Documents to Review

To render a power and authority opinion, the opinion giver must examine the entity's organizational documents to learn whether they permit the entity (a) to enter into the real estate secured financing, (b) to own the real property collateral, and (c) to conduct its business (assuming that the opinion recipient requested this opinion). The organizational documents to be reviewed are the following:

- **For corporations:** The articles of incorporation certified by the Secretary of State and bylaws certified by a client's certificate.
- **For limited partnerships:** The certificate of limited partnership and all amendments certified by the Secretary of State and the agreement of limited partnership certified by the client in a client's certificate.
- **For limited liability companies:** The articles of organization certified by the Secretary of State and the operating agreement certified by the client in a client's certificate.
- **For general partnerships:** The general partnership agreement certified by the client in a client's certificate.

The power and authority of a corporation is rarely a problem, because California law allows corporations broad authority to act, which is reflected in most corporate articles and bylaws. The organizational documents of general and limited partnerships and limited liability companies may restrict the entity's activities. If so, the opinion giver who has been asked to render an opinion that the entity has the power and authority to conduct its business should consider inserting an assumption on the type of business the entity is in fact conducting, which is a question of fact that the giver may not know with certainty.

The commentators and bar reports take the position that, unless it is specifically addressed in the third party legal opinion, the power and authority opinion is *not* an assurance that the entity has the governmental licenses, permits, and approvals to enter into the transaction with the opinion recipient, to conduct its business, or to operate the real property collateral. The ABA-ACREL Guidelines §4.3 (see §8.5) goes on to say that "[a]n opinion giver should not be asked for an opinion that its client possesses all necessary licenses and permits or has obtained all approvals and made all filings required for the conduct of the client's business."

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§8.37 2. Authorization to Execute and Deliver Loan Documents

In a typical third party opinion, the opinion recipient seeks specific assurance not only that the borrower or guarantor has the power and authority to enter into the transaction, but also that the borrower or guarantor has taken the actions required by its organizational documents to confer on its representatives (corporate officers, partners, or members) the authority to execute and deliver the transactional documents. The opinion recipient may also request an assurance from the opinion giver that those documents have in fact been executed and delivered by the authorized representatives of the borrower or guarantor, despite the fact that this is generally a question of fact, requiring no legal analysis by the giver.

To render the due authorization opinion, the opinion giver must take the steps described in one or more of §§8.30-8.34, depending on the type of borrowing entity.

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§8.38 a. Corporations

The opinion giver must either (1) be satisfied that the articles of incorporation and bylaws authorize the particular representatives of the entity signing on its behalf to execute the documents and bind the entity, or (2) obtain corporate resolutions.

An opinion giver that is relying on corporate resolutions must examine the articles and bylaws to ascertain whether the action being taken requires shareholder approval.

The opinion giver must verify that the particular representatives acting on the corporation's behalf are in fact the authorized representatives. If the resolutions or organizational documents authorize any one or more officers of the corporation to bind the corporation, the opinion giver must verify that the signatory is in fact an officer. An incumbency certificate signed by the secretary of the corporation, identifying the relevant signatories and their respective offices and containing sample signatures, customarily supports the opinion giver's conclusion on this point.

Items (1) and (2) above set forth a practical approach to the due diligence required to support a due authorization opinion. As a rule, these steps are adequate to assure an opinion giver who is familiar with the corporate client and its activities that its representatives in fact have the authority to act on the client's behalf. In theory, the due diligence that should be undertaken to ascertain the authority of corporate representatives would be far more extensive and time consuming, especially if the client has been in existence for a number of years. For a thorough determination of authorization, the opinion giver would have to verify that the board of directors that adopted the authorizing resolutions and the board of directors that elected the officers who are to act as signatories on the corporation's behalf were themselves properly elected and that their meetings were held in conformity with corporate law and the articles and bylaws of the entity. Such an effort is rarely undertaken, however. As one commentator has observed: "Ultimately, the opining attorney's due diligence will be a pragmatic compromise between exhaustive tracing of corporate and partnership records and blind faith that all organizational matters are in order." Joint Committee of the Real Property Law Section of the State Bar of California and the Real Property Section of the Los Angeles County Bar, *Legal Opinions in California Real Estate Transactions*, 42 Bus Law 1139 (1987).

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§8.39 b. Limited Partnerships

California's Revised Limited Partnership Act (Corp C §§15611-15724) will be replaced, over a 2-year period, by the Uniform Limited Partnership Act of 2008 (Re-RULPA) (Corp C §§15900-15912.07). Re-RULPA is applicable:

- To all limited partnerships formed after January 1, 2008;
- To all limited partnerships formed prior to January 1, 2008 that elect to be governed by Re-RULPA; and
- To all limited partnerships in any event after January 1, 2010.

See Corp C §15903.07 (partnership agreement determines voting rights of limited partners).

The general partner of a limited partnership often has the authority to sign on behalf of the limited partnership. In a real estate limited partnership with only one asset, the general partner, either under authority of statute or the partnership agreement, may need the express authorization of a majority of the limited partners to encumber the asset. A majority of the limited partners are required for a limited partnership to incur debt that is not in the ordinary course of business. Corp C §15636(f)(1)(B)-(C) (Corp C §15904.02, operative Jan. 1, 2008, for new or electing limited partnerships). For non-Re-RULPA partnerships, a written authorization (in the form of a ballot or a certificate) signed by a majority of the limited partners authorizing the general partner to execute the transaction documents on behalf of the limited partnership is necessary. If the limited partnership is subject to Re-RULPA, the limited partnership agreement should be read to determine the actual requirements for authorization. On limited partnerships generally, see Advising California Partnerships (3d ed Cal CEB 1999).

The opinion giver may wish to consider obtaining all the limited and general partners' signatures on a client's certificate to make sure that they are all in accord about the contents of the limited partnership agreement.

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§8.40 c. Limited Liability Companies

The opinion giver must examine the articles of organization and the operating agreement of the limited liability company to ascertain whether the entity is member managed or manager managed and whether the entity has officers. The opinion giver must also ascertain whether the articles of organization and the operating agreement authorize a specific individual or group to act on the limited liability company's behalf in entering into the transaction.

Generally, the opinion giver should require a written authorization by the body that manages the limited liability company, and by all members if that body lacks the authority to take the proposed action.

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§8.41 d. General Partnerships

A general partner usually has the power to bind the partnership, especially if the partnership agreement does not limit the partnership power of the individual partner. In practice, few opinion givers rely on the powers of a general partner under the Uniform Partnership Act of 1994, generally known by the acronym "RUPA" (for "Revised Uniform Partnership Act") (Corp C §§16100-16962), as support for a due authorization opinion. Corp C §§16301-16303.

Rather than rely solely on the powers granted under RUPA, the opinion giver should consider obtaining a written consent or authorization of all the partners to the execution and delivery of the loan documents and the actions the partnership must take in order to effect the transactions contemplated by the loan documents. Doing so may take the form of a partnership resolution, or it may be part of the client's certificate. For discussion of RUPA, see §6.40.

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§8.41A D. No-Conflict Opinion

Variously called a "no conflict opinion" or a "no breach or default opinion," in this opinion the opinion giver states that the transaction documents do not conflict with organizational documents (see §8.42), violate laws (see §8.43), cause a default under other agreements binding on the client (the Accord refers to these other agreements as "the other agreements") (see §§8.44-8.44l), or violate court orders (see §8.45).

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§8.42 1. With Organizational Documents

The portion of the no-conflict or no-breach opinion dealing with the entity's organizational documents adds little, if anything, to the power and authority and the due authorization opinions. The opinion giver need perform no additional due diligence to render the opinion—it is perhaps for this reason that the opinion has become commonplace.

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§8.43 2. With Laws

The conflict with laws opinion is, and should be, a no-violation-of-law opinion, rather than a no-conflict opinion. The potential breadth of a requested no-violation-of-law opinion must be considered and properly limited in scope. As noted in Accord §16, this opinion should not apply to all laws, but only to statutory law and regulations. The New York Mortgage Loan Opinion Report reached a similar result by limiting the definition of "law" to only laws that prevent the activity opined on and suggesting that the term applies only to the laws that a lawyer (note that some practitioners interpret the word "lawyer" in Accord §16 to refer to the opinion giver) would believe applicable in the exercise of customary diligence. The Opinion Principles that form a part of the ABA-ACREL Guidelines take a similar position on the law covered by an opinion. See ABA-ACREL Guidelines, App A, §II.B.

The activity to be opined on must be properly limited in scope. Often, an opinion recipient requests that the opinion cover performance by the borrower of all obligations under the loan documents. This request could be construed to be a backhanded way for the opinion recipient to receive an opinion that would otherwise be inappropriate. For example, in a construction loan situation, the borrower is obligated to build certain improvements. Obviously, to perform this obligation, the borrower must comply with zoning and land use laws. To opine that performance of all obligations, including the construction obligation, will not violate any law could (although it should not) be considered by the opinion recipient to constitute an opinion that the contemplated construction will be in compliance with zoning and land use laws.

The no-violation-of-law opinion should not be more extensive than an opinion that the execution and delivery of the loan documents, and performance of the payment obligations and the granting of the liens and security interests under the loan documents, will not violate any "law" (properly qualified) of the opining jurisdiction. Any request beyond this should be approached with a great deal of caution. See Paragraph 2.9 in form 8.78-1 and the exclusions in form 8.80-1.

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§8.44 3. With Other Contracts

The opinion recipient, a lender, requests the no breach or default opinion out of concern that the loan it is about to make may trigger acceleration of other debt binding on its new borrower or the assertion by another creditor of a lien on an equal footing with that of the recipient under a negative pledge provision. See Commentary to Accord §15.1. As with other opinions, the no breach or default opinion generally finds its justification in the role it plays assisting the opinion recipient in completing its due diligence.

It can be argued that the no breach or default opinion fulfills this function because it is commonly found in opinion requests, especially in large transactions. Aware that the lender will probably require a no breach or default opinion, borrower's counsel will likely warn the client of the necessity for reviewing major contracts, and might even begin gathering and reviewing such contracts in the early stages of the transaction. Copies of major contracts are also likely to make their way into the hands of lender's counsel for review. In most transactions, the no breach or default opinion is an opinion on documents that counsel for both the borrower and the lender not only have reviewed but have concluded will not cause problems for the contemplated lending transaction. At the closing, the no breach or default opinion itself is little more than an expression of the consensus of both borrower's and lender's counsel that the loan will not breach any important contract binding on the borrower.

PRACTICE TIP: The discussion above assumes that the borrower's counsel has reviewed other contracts binding on his or her client. In many transactions, the no breach or default opinion is simply the opinion giver's confirmation that, after doing no real investigation, the opinion giver knows nothing about the client's affairs that should cause the opinion recipient to worry. Because this sort of no breach or default opinion is of dubious worth to the opinion recipient, lender's counsel should refrain from requesting it and the opinion giver should resist giving it.

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§8.44A a. Issues Confronting Opinion Giver

Despite questions about the value of a no breach or default opinion in most real estate lending transactions, this opinion is common and does pose issues and problems for the opinion giver, including the following:

- **Opinion formulation.** The proper formulation of the opinion is a subject of discussion in the opinion literature, as the uncertainty over the proper name for the opinion suggests. The formulation issue relates to the scope of the opinion and the related issue of the degree of due diligence the opinion giver is expected to perform. See §8.44B.
- **Due diligence burden.** If the client is a large enterprise, the volume of other agreements binding on it may make the opinion giver's review impractical or very costly. The issue is how to narrow the scope of the opinion giver's due diligence. See §8.44C.
- **Choice of law in other agreements.** The other agreements may contain choice of law provisions selecting a jurisdiction other than the jurisdiction of the opinion giver. According to the opinion literature, the opinion giver does not have to engage local counsel to review those contracts. See §8.44D.
- **Issues of contract interpretation.** The transaction documents may contain provisions that might violate one or more provisions in another agreement.
- **Factual assumptions and financial covenants.** The provision in the other agreement might be a financial covenant that will be breached if the client adds more debt. Does the opinion giver have to verify that the client is in compliance with its financial covenants?
- **Extrinsic evidence bearing on contract interpretation.** The parties to the contract being reviewed by the opinion giver might have taken actions or expressed their understanding of the meaning of a provision of the reviewed contract that is inconsistent with its terms. According to the opinion literature, the opinion giver is not required to look beyond the "four corners" of the other agreement in reaching a conclusion about its meaning.
- **The unclear provision.** A provision in the other agreement might be unclear. Construed one way, the provision might prohibit one or more aspects of the transaction contemplated by the transaction documents. Construed another way, the provision might permit, or at least not prohibit, the transaction. Should such a provision be the subject of an opinion, to what extent is the opinion giver insuring the opinion recipient that its view of what the contract provision means or how it should be construed is going to be shared by the courts? The opinion literature gives little guidance on this issue. The authors believe that such a provision should not be the subject of a legal opinion. If, nonetheless, an unclear provision becomes the subject of a third party legal opinion, the opinion itself, whether reasoned or "clean," should be viewed not as a prediction of how a court will construe or should construe the provision, but as the expression of the opinion giver's viewpoint about one meaning to which the provision is reasonably susceptible. On unclear provisions, see §§8.44E-8.44I.

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§8.44B b. Opinion Formulation

Owing to the ambiguity of the term "conflict," the Accord and other opinion reports prefer the designation "no breach" or "default" for the opinion that the execution, delivery, and performance of the loan documents do not "conflict with/result in a breach or default under" any other agreements binding on the borrower. The Accord then goes even further, stating that the term "conflict with" in an opinion must be construed to mean no breach or default.

There is a debate on whether the no breach or default opinion should extend to the performance of all covenants and agreements in the transaction documents, or should be more limited in scope. The opinion literature is in agreement that the opinion should cover execution and delivery of the loan documents and payment of the indebtedness under the loan documents. Counsel for opinion recipients often request the opinion giver to state that the "performance" of the transaction documents does not give rise to a breach or default under any other agreements binding on the client. The opinion literature takes different approaches, however, on whether the performance of other obligations under the loan documents should be included in a no breach or default opinion, and, if so, subject to what limitations. The Accord suggests a formulation that includes performance of agreements, but it limits the no breach opinion to performance of mandatory, rather than permissive, obligations. See Paragraph 2.8 in form 8.78-1. On the other hand, adopting an approach favored by the authors of this chapter, the New York Mortgage Loan Opinion Report states that it is appropriate to limit the opinion to payment obligations because of the magnitude of the performance obligations under most loan documents and the difficulty in predicting the impact of future performance on other agreements.

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§8.44C c. Due Diligence Burden

For longstanding operating clients who have executed many agreements, the review burden can be overwhelming and not cost-effective, even if the opinion giver law firm represented the client in entering into most if not all such agreements. If the borrower is a newly formed entity, the burden may be insignificant, other than, perhaps, for already existing contracts and agreements assumed by the entity in connection with the consummation of the transaction. It is therefore proper to limit the scope of the investigation required to contracts listed in a schedule attached to the opinion. These contracts may include, *e.g.,* other loan documents (or public debt instruments) binding on the borrower or guarantor, as applicable, planned unit development documents, reciprocal easement agreements, or ground leases.

If the client is party to a large number of contracts, making review by the opinion giver time-consuming and costly, the opinion giver may be tempted to do one of two things:

- Apply the knowledge qualification not only to the existence of other agreements but to the existence of conflicting provisions in the other agreements; or
- Rely on a client's certificate that no breach or default exists in any of the other agreements.

Both of these approaches are problematic. If the opinion giver knows that other agreements bind the client, the opinion giver should either examine them to ascertain if the transaction documents will cause a breach or default under the other agreements, or expressly state in the opinion that the opinion giver has not examined the other agreements known to him or her.

PRACTICE TIP: An opinion giver may state that, to his or her knowledge, the loan documents will not give rise to a breach or default under any other document binding on the client. Generally, what the opinion giver means, and perhaps should be viewed as intending to say, is that although there may be documents binding on the client and although those documents may contain provisions that the loan transaction might breach, the opinion giver has no current actual knowledge of any of those provisions because the opinion giver has not recently examined any of those documents.

Relying on a client's certificate about the absence of a breach or default is particularly inappropriate, because, as the commentators note, the determination of whether a conflict exists involves the exercise of legal judgment. In addition, although it may be appropriate in some circumstances to limit the other agreements to those known to the opinion giver, it is better practice to list the other agreements to avoid a later argument over whether the opinion giver knew or should have known of a particular agreement that later surfaces as a problem. See ABA-ACREL Guidelines §3.4 n12, which notes a trend away from the practice of applying the "knowledge" qualification to the "no breach or default" opinion.

PRACTICE TIP: The question then arises, who prepares the list of other agreements? The client clearly must participate in this process, if only to keep the list as short as possible in order to minimize the legal bill. Lender's counsel and the opinion giver will have to ascertain the types of contracts that the opinion giver should review in light of the loan being made. Given the role of the no breach or default opinion in the transaction, the list of other documents to be reviewed by the opinion giver should be limited to ones that are significant to the client's financial well-being and ongoing business activities.

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§8.44D d. Choice of Law in Other Agreements

Accord §4 permits the opinion giver to assume that the other agreements to which the client is bound are enforceable in accordance with their terms. Other agreements binding on the client are often governed by the laws of a state other than those of the opining jurisdiction. A California lawyer may be asked to render an opinion on whether an agreement that by its terms is governed by New York law will be breached if the client enters into a loan agreement governed by California law. In the absence of an assumption that the New York documents will be enforced as written, the California opinion giver would have to hire New York counsel to decide whether the provisions of the California loan documents would result in a breach of the New York documents. If the client has multiple contracts governed by the laws of several different jurisdictions, the cost of the no breach or default opinion would be prohibitive. The assumption of enforceability eliminates the need to examine the other agreements under their respective governing laws. In deciding whether the California loan documents create problems under other agreements binding on the client, the opinion giver may assume that any court will enforce the provisions of the other agreements as written.

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§8.44E e. The Unclear Provision

The role of the no breach or default opinion is brought into relief when it is unclear whether the language of a provision in another agreement binding on the client prohibits one or more aspects of the transaction contemplated by the transaction documents. The ubiquity of opinion letters in finance transactions means that counsel for a borrower will likely be sensitive to possible conflicts between significant contracts binding on his or her client and the provisions of the transaction documents. If a significant contract contains a provision that might conflict with the transaction documents, borrower's counsel will bring the provision not only to the attention of the client but, with the client's permission, to the attention of counsel for the opinion recipient, the lender.

NOTE: Borrower's counsel is often placed in an awkward position when the lender and its counsel become aware of an issue of contract interpretation. The borrower will urge its counsel to make the argument to the lender's counsel that the potentially troublesome provision should be read in a way that permits the transaction under the transaction documents to be consummated, at the least cost to the borrower. Consent to the transaction documents by the party or parties to the other agreements may be possible, but it may be costly, if the other party wants something in return for a consent, or time-consuming, if there are multiple parties (*e.g.,* multiple banks under a bank line or multiple holders of debt under a public debt instrument). In addition, borrower's counsel, as opinion giver, is well aware that the more forceful he or she is in making the argument, the more likely he or she is going to be asked by lender's counsel to render a "clean" opinion on the issue. The conflict between opinion giver and its client discussed in §8.13 is very much a reality in these situations.

The wide variety of contract terms makes it difficult to give an example of a troublesome provision that will resonate with a large number of practitioners. Moreover, in this world of special purpose, bankruptcy-remote entities with few, if any, other significant contracts binding on them, the troublesome provision in another agreement is much less common, except perhaps when the debt is guaranteed by the parent of the special purpose entity. In most cases, the issue arises when the borrower is a relatively large entity with public debt or with a large bank line of credit.

EXAMPLE: Assume the bank line or the public debt instrument contains restrictions on further indebtedness but provides an exception for certain types of project finance, such as a loan secured by a single parcel of real estate owned by the borrower that is "nonrecourse." Further assume that the exception does not define "nonrecourse." The issue for the opinion giver is whether the financing being provided by the potential opinion recipient is nonrecourse, within the meaning of the public debt instrument or bank line. Most "nonrecourse" real estate loans contain exceptions, so-called "nonrecourse carve-outs," which permit the lender to pursue the borrower if the borrower takes certain actions (such as transferring the encumbered property in violation of a due-on-sale clause), or misappropriates property revenue. For the opinion giver, the task is to determine whether a nonrecourse loan with nonrecourse carve-outs is still a nonrecourse loan under the exception to the debt restriction in the other document. In a confrontation with the opinion recipient's counsel, the opinion giver may argue that his or her client's position is that it is still a nonrecourse loan. The opinion recipient and its counsel will no doubt reply that if the opinion giver is so certain of his or her reading of the provision, the opinion giver should be willing to give a "clean" opinion on the issue.

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§8.44F (1) Difficulty With Issuing "Clean" Opinion

The authors believe that an opinion recipient should not ask for a clean opinion on an unclear provision (see §8.44E), and an opinion giver should resist giving it. A reasoned opinion may be appropriate in some circumstances, but it may also be imprudent to fill the lender's files with what amounts to a legal brief setting out the arguments for and against a particular interpretation of the unclear provision.

The clean no breach or default opinion in the face of an unclear provision does nothing to advance the due diligence function of the no breach or default opinion. Both opinion giver and opinion recipient are aware that there is an issue, and both know what the issue is. The provision could mean one thing, which would permit the loan transaction to go forward without the borrower triggering a default under the other agreement, or another thing, which would create a problem for the borrower, and an increased credit risk for the lender. The opinion recipient and its counsel understand the arguments for and against each interpretation and, in closing the transaction, the opinion recipient is not relying solely on the clean opinion of the opinion giver. A clean no breach or default opinion in the face of an unclear provision is not intended by the opinion giver, and should not be understood by the opinion recipient, to be a guaranty that a court will adopt the opinion giver's interpretation of the provision. What, then, do opinion giver and opinion recipient intend such an opinion to be? Before answering this question, a closer examination of the contract interpretation process in the context of the no breach or default opinion is necessary. See §§8.44G-8.44I.

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§8.44G (2) Contract Interpretation Process

As noted in §8.44C, the commentators and opinion reports have addressed the due diligence that the opinion giver is expected to undertake in rendering a no breach or default opinion. Under Accord §4(m), if the other agreement is governed by the law of a jurisdiction other than that of the opinion giver, the opinion giver may ignore the effect of the choice of law by assuming the contract provisions of the other agreement are enforceable in accordance with their terms. The opinion giver does not need to inquire into whether the parties to the other agreement had an understanding about the meaning of a particular provision or whether their actions after the contract was executed gave a practical interpretation to the words used in the contract, unless in each case the opinion giver has knowledge of any of these factors bearing on the meaning of the words used.

For the reports and commentators, the role of the opinion giver is to look at the words in the other agreement, assume their enforceability, and arrive at a determination on whether the loan documents will cause a breach or default under the other agreement. As one commentator put it, "as a matter of customary practice the opinion preparers are entitled to interpret the terms of the contract in accordance with their plain meaning." FitzGibbon & Glazer, FitzGibbon and Glazer on Legal Opinions: What Opinions in Financial Transactions Say and What They Mean, 1992 (1999 Supp) §16.3.4 at 1. Plain meaning, at least for an "unambiguous" provision, is apparently the meaning that a reasonable third party would ascribe to it. Glazer & FitzGibbon §16.3.4 n32 at 502: 2006 Supp 309. The issue that the opinion literature does not address is what happens if there is no "plain meaning" for a particular provision, or, if as often happens, reasonable third parties might differ on the meaning of a seemingly unambiguous provision.

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§8.44H (a) The Meaning of Words: Basic Contract Interpretation

When a lawyer or a judge says that a contract provision has a plain meaning, he or she is saying that there is no need to consider evidence of intent of the parties other than the words of the document. In the leading California case on contract interpretation, written more than 30 years ago, Justice Traynor expressed the realistic view of Arthur Corbin that "[w]hen the court interprets a contract on [the basis of plain meaning], it determines the meaning of the instrument in accordance with '… extrinsic evidence of the judge's own linguistic education and experience.'" *Pacific Gas & Elec. Co. v G.W. Thomas Drayage & Rigging Co.* (1968) 69 C2d 33, 36, 69 CR 561. Justice Traynor went on to observe (69 C2d at 37):

> A rule that would limit the determination of the meaning of a written instrument to its four-corners merely because it seems to the court to be clear and unambiguous, would either deny the relevance of the intention of the parties or presuppose a degree of verbal precision and stability our language has not attained.

The notion of "plain meaning," for Corbin and Traynor, "reflects a judicial belief in the possibility of perfect verbal expression," which in turn is "a remnant of a primitive faith in the inherent potency and inherent meaning of words." 69 C2d at 37. In *PG&E*, the California Supreme Court held that the test of admissibility of evidence to determine the meaning of a provision is not whether the provision is clear or ambiguous, but whether the evidence proffered is relevant to prove a meaning to which the language is "reasonably susceptible." 69 C2d at 40.

Although Justice Traynor rejected the notion that words have a plain meaning, he did recognize that words are susceptible only to certain meanings. In determining whether to admit evidence on the meaning of a provision, the courts must determine whether the words are reasonably susceptible to the meaning for which a party is seeking to produce evidence. It is not that the meaning of the provision is clear or plain, but that the meaning for which evidence is being offered is one to which the provision is reasonably susceptible. In the example in §8.44E, a provision in another agreement permitting nonrecourse loans is reasonably susceptible to at least two meanings. It could cover only loans that have no exceptions to the nonrecourse provision or it could cover loans that have nonrecourse exceptions that are common to commercial loan transactions. Under the holding in the *PG&E* case, a court would have to admit evidence on this issue.

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§8.44I (b) The Meaning of Words: Contract Interpretation and Legal Opinions

In the opinion literature, the process of rendering a no breach or default opinion is very different from the process that the courts follow in construing a contract or that counsel follows in advising a client. As noted in §8.44G, the opinion giver may assume that the provisions of the other agreements are enforceable in accordance with their respective terms, regardless of what the governing law of the other agreements might be. The Accord and the commentators appear to say that an opinion giver need not undertake to determine whether there is evidence outside the documentation being reviewed that may have an impact on the meaning of a provision in another agreement. Under the Accord, however, if the opinion giver has actual knowledge of such evidence, the opinion giver cannot reasonably rely on an assumption about the nonexistence or irrelevance of such extrinsic evidence.

Nonetheless, for the opinion commentators and reports, the task of the opinion giver is not to interpret the provisions of the other agreement (or even of the loan documents), in the sense of arriving at what the parties intended by the words they used, because the opinion giver is not required to inquire into what the parties to the other agreement might have intended. Nor is it the opinion giver's task to opine on the proper construction of the provision, in the sense of ascertaining the legal effect a court might give to the provision once its meaning is determined, because the opinion giver is not required to research the courts' treatment of the provision in question. The sole task of the opinion giver is to look at the words of the other agreement in light of the opinion giver's current actual knowledge about both the agreement in question and judicial pronouncements on the provision in question to determine whether those words pose problems for the loan documents.

As noted above, unlike a court, an opinion giver is not in a position to gather together or pass on evidence of intent beyond the words in the agreement. If an opinion giver were to opine on the significance of an exception for nonrecourse debt to the transactions contemplated by the loan documents, the opinion giver would not be expressing a judgment about the intent of the parties to the other agreement. Also unlike a court, an opinion giver is not researching the manner in which the appellate courts of the jurisdiction whose law governs the other agreement would construe the provision in question, *i.e.*, give it legal effect, which is a process distinct from interpretation. See Perillo, ed., Corbin on Contracts §4.1 (rev ed 1993). An opinion giver is therefore not interpreting or construing the contract provisions in other agreements in a no breach or default opinion, at least not in the manner a trier of fact or court would interpret or construe contract provisions. In rendering a clean no breach or default opinion in the face of an unclear provision, an opinion giver essentially is saying that the words of a provision in another agreement are reasonably susceptible to a meaning that does not prohibit the transaction contemplated by the loan documents.

The words of another agreement may be reasonably susceptible to other meanings. In the example in §8.44E, an opinion giver who says that the loan documents do not give rise to a breach or default under another agreement prohibiting all debt other than nonrecourse debt, when the loan documents contain carve-outs from the nonrecourse provision, is saying that the nonrecourse provision in the other agreement should be read in light of the prevailing practice of lenders to provide a number of carve-outs to the general prohibition against recourse. The opinion giver is not saying that a court will hold that this is the proper meaning of the provision in question; he or she is not even saying a court should so hold. The opinion giver is merely saying that, in his or her experience, this is a meaning to which the provision is reasonably susceptible. Having compelled the opinion giver to make a statement about the unclear provision, the opinion recipient should be held to understand that the opinion giver is making only a very limited statement on the issue, one that the opinion recipient's own counsel could make and no doubt has made, and therefore one of doubtful worth.

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§8.45 4. With Court Orders

The same issues described in §§8.44-8.44I with respect to other contracts generally apply to court orders as well. The concept of default does not apply to court orders; instead, the proper formulation for this opinion is no breach or violation.

Certainly the opinion giver cannot be expected to know of all court orders that might affect the borrower and is justified in relying on the borrower's certification on court orders and a review of the court orders listed in the certificate. It is not unusual to bypass the certification and review process, and limit the opinion to those court orders actually known to the opinion giver. In the latter case, the court orders to which the opinion is directed would only be orders specifically affecting the borrower or the security property.

PRACTICE TIP: As with other agreements, the listing of court orders is preferable to reliance on the knowledge qualification because the list avoids any later argument that the opinion giver knew or should have known of the provisions of a particular court order. See Paragraph 2.8 in form 8.78-1.

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§8.46 E. No-Litigation Opinion

In a no-litigation opinion, the opinion giver is being asked to state whether, to the giver's knowledge, any actions, suits, or proceedings are pending or threatened against the borrower or guarantor client. In a real property secured transaction, this opinion is often expanded to include pending or threatened actions, suits, or proceedings involving the real property collateral. On knowledge, see §8.19.

The no-litigation opinion addresses issues of fact and requires no legal judgment or analysis by the opinion giver. To support the opinion, the opinion giver must engage in factual research to determine whether the client, or the collateral being encumbered by the opinion recipient, is involved in an action, suit, or proceeding. An action, suit, or proceeding either does or does not exist. The opinion giver need not (indeed, cannot) exercise legal judgment on the issue. For sample, see form 8.88-1.

NOTE: The Boston Bar Association's Streamlined Form of Closing Opinion attempts to limit the no-litigation in novel ways; the opinion covers only litigation engaged in by the opinion giver challenging the transaction itself. Glazer & FitzGibbon §17.1, 516 n1: 2006 Cum Supp 313.

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§8.47 1. Scope of Due Diligence

The no-litigation opinion raises the twin, and often intertwined, issues of the propriety of a request for a no-litigation opinion and the scope of the opinion giver's due diligence to support the opinion. From the perspective of the opinion recipient, the no-litigation opinion can be of considerable benefit if backed by in-depth factual research by the opinion giver. A lender has a legitimate concern as to whether its borrower, guarantor, or collateral is involved in litigation that could adversely affect loan repayment.

The opinion giver, however, is trained to exercise legal judgment on the facts, not to gather them. With one narrow exception, the opinion giver is in no better position than the opinion recipient to search court files and to ask the borrower or guarantor whether any litigation is pending or threatened. The narrow exception is in the possible knowledge of an opinion giver who regularly represents the borrower or guarantor or who has dealt with the property. In this situation, the opinion giver may know something that is not in the court records and that the client may be reluctant to reveal. This information about the borrower, guarantor, or real property collateral, which the opinion giver may be uniquely situated to possess, constitutes the limited benefit that the no-litigation opinion may confer on the opinion recipient. It is with the possibility of this limited benefit in mind that one can weigh the scope of the opinion giver's due diligence in rendering the no-litigation opinion.

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§8.48 a. Court Docket Search

Commentators and reports take the position that, in rendering a no-litigation opinion, the opinion giver should not be expected to undertake a docket search to learn whether an action, suit, or proceeding is pending. See the 1998 Tri-Bar Report, cited in §8.5. A search service or the lender's personnel or its counsel can examine relevant court dockets as easily as the opinion giver or its personnel. Moreover, an opinion that is expressly based on the results of a docket search is not truly an opinion; it is merely a vehicle for transmitting the results of the search. See form 8.88-1.

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§8.49 b. Law Office Personnel and Files

A more vexing question is the scope of the inquiry that the opinion giver must undertake of its own files and the lawyers in its office. The Accord takes the position that the no-litigation opinion does not imply that the opinion giver conducted any factual research on litigation apart from obtaining a certificate of the opinion giver's client. Other commentators have adopted the approach of the American Bar Association to the preparation of responses to audit letter requests, which requires canvassing lawyers in the firm on their knowledge of existing litigation. The latter approach may not function well for the typical transaction, with its unpredictable timetable for closing.

If the opinion recipient expects the opinion giver to undertake due diligence beyond obtaining a certificate from the client in rendering the no-litigation opinion, the recipient should delineate its expectations early on in the transaction and discuss with the opinion giver a realistic, and cost effective, means to accomplish the due diligence effort, including any research updates needed to ascertain the litigation status as of the closing date.

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§8.50 2. Determination of Materiality

If the borrower or guarantor is a large enterprise that attracts multiple suits, especially personal injury and other tort actions, most of which are likely to be covered by insurance, the issue arises whether the opinion giver should be opining on whether the suit is "material" to the operations of the borrower or guarantor. The opinion giver is not in a position to make such a judgment, which involves ascertaining the client's financial strength and the impact a judgment, however small, may have on the client's business operations.

Although the opinion giver may be in a position to evaluate the merits of a particular case and give an opinion on the chances of the client's success in the matter, the commentators' position is that the giver should not be expected to undertake such an inquiry and analysis. ABA-ACREL Guidelines §4.7 puts it succinctly: "The opinion giver ordinarily should not be asked to express an opinion on the expected outcome of pending or threatened litigation."

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§8.51 3. Real Property Collateral

In a real property secured transaction, the opinion recipient may request that the no-litigation opinion extend to the real property collateral. The formula often used is that there are no pending or threatened actions, suits, or proceedings "affecting" the real property collateral. If the scope of the opinion giver's due diligence is limited to the actual knowledge of a select group of lawyers in the opinion giver's firm and a client certificate, the breadth of the opinion formula is of little consequence. If the due diligence is to be expanded beyond these narrow limits, the opinion giver must consider the kinds of proceedings that may have an adverse effect on the value of the real property collateral that may not show up on a court docket. Examples are administrative proceedings involving land use or environmental matters. The expansion in the expected scope of due diligence must be accompanied by a carefully crafted delineation of the kinds of proceedings in which the opinion giver must undertake research.

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§8.52 F. Remedies or Enforceability Opinion

The remedies opinion (also known as the enforceability opinion) is the core of the third party legal opinion, although it consists of a simple statement that the transaction documents are enforceable against the opinion giver's client under their respective terms. The opinion may be short, but the exceptions to it may run for pages, despite valiant efforts by commentators and bar committees to steer the bar toward a few broadly worded qualifications. Both the opinion and the qualifications to it are the subjects of debate among practitioners and scholars, and, as one might expect, a considerable amount of toner has been consumed in efforts to define the proper meaning of the opinion and the propriety and wording of the qualifications. In 2004, the State Bar of California issued a report, updated in 2007 (see California 2007 Remedies Report, cited in §8.3), launching an assault against the remedies opinion and urging counsel to abandon the custom of requiring such opinions whenever opinions are part of a transaction. Sections 8.53-8.58 cover some of the issues surrounding the remedies opinion and the various ways in which the reports and commentators have tried to resolve those issues. For a sample remedies opinion, see Paragraph 2.4 in form 8.78-1. That form continues to use the phrase "legal, valid, and binding," even though according to Glazer & FitzGibbon §9.6: 2006 Cum Supp 132, the word "legal" is not ordinarily found in the phrase of late, ostensibly to eliminate the concern that the opinion covers violations of law having nothing to do with the enforcement of the contract, even though we are told that as "a matter of customary practice" the term "legal" does not cover such laws or their violation. The qualifications to that opinion are set out in Paragraphs 3.3-3.8 in forms 8.81-1—8.86-1.

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§8.53 1. Each and Every Approach

Although brief and straightforward, at least on the surface, the remedies opinion has generated some heated discussions over what it means or should mean. There are two camps in this debate: One camp maintains that the phrase "enforceable in accordance with its terms" means that the courts will enforce each loan provision as it is written and will provide a remedy for a breach of each of the borrower's or guarantor's obligations under the loan documents. The advocates of this interpretation of the remedies opinion, often referred to the "each and every" approach, argue that they are merely giving effect to the plain meaning of the words. The Accord adopted the "each and every" approach. For discussion of both approaches, see the Business Law Section of the State Bar of California Report on the Third-Party Opinion Report of the American Bar Association Section of Business Law (1992) (Business Law Report).

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§8.54 2. Essential Benefits Approach

The second camp in the debate over the meaning of the remedies opinion maintains that the opinion giver is assuring the opinion recipient only that the courts will give the recipient the essential benefits of the loan documents. This "essential benefits" approach was advocated in *Legal Opinions in California Real Estate Transactions*, 42 Bus Law 1139, 1158 (1987) in these words: "[T]he enforceability opinion should be construed to cover only the basic contract remedy of an action at law for damages following a material breach of the contract or, in the case of a loan transaction secured by a deed of trust on California real property, an action or proceeding to foreclose the lien of the deed of trust in accordance with California law."

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§8.55 3. Compromise Position

The advocates of the "essential benefits" approach argue that the "each and every" approach imposes a Herculean research burden on the opinion giver to establish the enforceability of each provision of the ever-expanding modern loan documentation. To this argument the proponents of the "each and every" approach counter that the customary exceptions and limitations to the remedies opinion make manageable the research burden their approach requires. This argument, respond the "essential benefits" advocates, leads to a laundry list of exceptions extending for many pages and generating esoteric and expensive discussions between counsel. Moreover, they argue, the list cannot possibly address all possible exceptions to the broad statement that hundreds of pages of loan documents are enforceable as written.

A truce exists between the two camps on what the remedies opinion should mean. The form opinions that the various reports and commentators have developed in response to the Accord contain an exceptions list of a respectable length, coupled with one of the various formulations of what has become known as the "generic exception and assurance." The generic exception is a broadly worded carveout from the statement that all loan document provisions are enforceable as written. The generic exception says that some may not be. The "assurance" returns a portion of what the generic exception takes away. The "assurance" may be worded broadly, using words such as "essential benefits" to describe what the lender is actually going to enjoy from the multitude of provisions in the loan documents, or narrowly, describing in detail the remedies that the courts will provide the lender if there is a material default. In form 8.78-1, the "assurance" takes the form recommended by the ABA-ACREL Guidelines (§4.0) to specify the remedies available to the lender on a material default. With the generic exception and assurance and a litany of specific exceptions, the remedies opinion can have the broad meaning advocated by the "each and every" camp and yet afford the opinion giver the benefit of the more limited interpretation advocated by the "essential benefits" camp. The authors of the ABA-ACREL Guidelines believe that the generic exception and assurance, when coupled with the accepted equitable principles limitation, eliminate the need for many, if not all, of the exceptions that continue to adorn large numbers of legal opinions. ABA-ACREL Guidelines §4.0.

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§8.56 4. Qualifications

Commentators and bar reports have long criticized the recitation of numerous more or less specific qualifications to the remedies opinion, but to little avail, at least in California. The form opinion in §§8.76-8.90 contains several exceptions to the remedies opinion compiled from the Accord, the ABA-ACREL Form Opinion, and the 1995 California Real Property Legal Opinion Report of a Joint Committee of the State Bar of California and the Los Angeles County Bar Association, 13 Cal Real Prop J 1 (Fall 1995).

The qualifications range from the widely recognized, such as the bankruptcy and equitable principles qualifications (see form 8.81-1), to very specific California qualifications (see form 8.84-1), such as the limitations on the enforcement of indebtedness secured by real property. The Comments in the form opinion discuss the qualifications.

Although the list of qualifications in the form opinion may be comprehensive, the inclusion of that list in an opinion is not a substitute for a review of the loan documents. After the review, it may be necessary to add to the list of qualifications all unenforceable provisions in the documents that may not be subsumed within the qualification list or that otherwise appear to be significant to the opinion recipient in the context of the transaction. For example, a provision in a deed of trust that provides for "partial foreclosure" for "a portion of the debt," or that provides for foreclosure without acceleration of the debt, should be the subject of a qualification.

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§8.57 5. Limitations of Remedies Opinion

An opinion that the loan documents are enforceable in accordance with their terms may imply that the opinion giver has considered the impact of all local, state, and federal laws, no matter how specialized, on the loan documents. Despite its broad interpretation of the remedies opinion, the Accord does not venture this far. Both Accord §18 and ABA-ACREL Guidelines §1.5.a generally disclaim implied opinions, and Accord §19 and ABA-ACREL Guidelines §1.5.a set out several specific legal issues that are not covered by the remedies opinion unless they were specifically addressed.

California practitioners should note that under the Accord, the ABA-ACREL Guidelines, and the form opinion in §§8.76-8.90, a remedies opinion implies that the loan documents do not violate California's usury laws. This implication generally requires the opinion giver to inquire about the relevant exemption from the usury laws applicable to the opinion recipient or the exception to the usury laws into which the transaction might fall. On usury, see §§3.37-3.44.

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§8.58 6. Implications of Remedies Opinion

Although Accord §19(h) disclaims any opinion on characterizing the transaction as creating a lien on real or personal property, the remedies opinion in a real property secured transaction implies not only that the documents create a lien (without, however, implying an opinion on title to the property subject to the lien) *between borrower and lender*, but also that the transaction characterization between the parties is as stated in the documentation (*i.e.,* if the documents purport to create a loan, the remedies opinion implies that the courts will enforce the documents as a loan, not as a lease or a partnership *between borrower and lender*). See *Legal Opinions in California Real Estate Transactions*, 42 Bus Law 1139, 1161 (1987); ABA-ACREL Guidelines §4.0.c.

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§8.58A 7. Customary Documents and Remedies

Opinion recipients represented by out-of-state counsel in a transaction that may or may not involve multistate elements sometimes request an opinion that the loan documents are in a form or contain provisions customarily used in California in connection with loans of the type subject to the opinion or provide substantially all of the "benefits" typically available to real estate secured lenders in California. An opinion recipient may even request an opinion that the loan documents are legally adequate for the opinion recipient's intended purposes, or any one of a number of equally broad formulations that, in effect, place the opinion giver in the position of advising the opinion recipient as though the opinion recipient were a client. The ABA-ACREL Guidelines state that opinion requests of this sort are inappropriate and should not be made, because legal opinions address only specific legal issues and should not be "in the nature of 'broader guidance and counsel.'" ABA-ACREL Guidelines §1.1.b.

The ABA-ACREL Guidelines acknowledge that there may be instances when an opinion recipient and opinion giver appropriately agree on a form of opinion that is broad in scope. If the opinion recipient has not hired its own local counsel because the transaction will not support the cost of two local counsel, an opinion recipient may request a more limited assurance from the opinion giver "to the effect that the loan documents do not omit essential remedies that in the opinion giver's experience are generally found in similar documents for comparable mortgage loan transactions in the opinion giver's jurisdiction." ABA-ACREL Guidelines §1.1.b. A sample form for this opinion is provided in Paragraph 2.12 in form 8.78-1. The ABA-ACREL Guidelines point out that this is not an opinion but an expression by the opinion giver of his or her experience in transactions comparable to the one being opined on. The ABA-ACREL Guidelines do not discuss any of the subtle issues this type of opinion raises, such as, for example, on whose experience is the opinion based, the junior associate who may have drafted the opinion or the entire real estate department of the firm? The ethical problems that these types of opinions pose are, however, discussed in the ABA-ACREL Guidelines.

A written assurance that loan documents provide remedies that the opinion giver feels are customary raises no particular ethical issues if the opinion giver concludes that the loan documents contain such remedies. The ethical issue arises if the opinion giver concludes that the loan documents do not contain customary remedies. The opinion giver must advise the opinion recipient of the defects in the loan documents in order to render the opinion. Before advising the opinion recipient of such defects, however, the opinion giver must obtain the informed consent of his or her client. ABA Model Rules of Prof Cond 2.3(b). The opinion giver will be in a very awkward position if the client withholds consent and the opinion giver must inform the opinion recipient that the assurance cannot be given, without stating why. The ethical minefields that exist with this type of assurance require that the opinion giver either resist giving the opinion or obtain client consent at the very outset of the transaction, lest the later uncovering of a deficiency in the loan documents place the opinion giver in an untenable situation.

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§8.59 G. Reasoned Opinion

On occasion, an opinion recipient requests the opinion giver to render an opinion on a matter that is legally uncertain. This request may be made because the courts have not addressed the issue, because courts that have addressed it have arrived at different conclusions, or because the issue is one of contract interpretation (*e.g.,* in determining whether the execution and delivery of the loan documents will result in a breach or default under another agreement, the meaning of a provision of the other agreement becomes an issue). Faced with such a request, the opinion giver must craft a reasoned argument on which to base a prediction about what the courts would do under the circumstances. The opinion that follows the argument will reflect the degree of conviction that the opinion giver has in the argument being presented. There are various formulations of the "reasoned opinion." The opinion giver might state that the courts "would" take a certain action or hold a certain way, or if the giver is less certain, the statement might be that the courts "should" or "more likely than not would" take the action or adopt the holding. Although earlier opinion reports examined the distinctions between these various formulations, see ABA-ACREL Guidelines §3.5, which takes the position that a "should" opinion has the same meaning as a "would" opinion.

Perhaps the most commonly requested reasoned opinion in real estate and business transactions is the choice-of-law opinion, discussed further in §§8.61-8.63, which deals with opinions in multistate transactions.

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§8.60 H. Opinions in Multistate Transactions

Real estate secured loan transactions may involve multistate elements and considerations, which can arise when the real estate is located in California and the lender selects the law of another state to govern the transaction. Multistate issues can also arise in complex transactions involving, *e.g.,* a loan secured by properties in a number of states.

Many real estate loans involve multistate issues and, if a personal property perfection opinion is requested, the opinion giver must ascertain the propriety and scope of such an opinion. See the discussion in §§8.73-8.75 in light of the enactment of revised Division 9.

The format of the loan documents, and their specific provisions, can also complicate the situation. In some transactions the loan agreement and the promissory note may be governed by the law of another state, while the deed of trust and assignment of rents and leases are governed by California law. The documents may have overlapping provisions. The deed of trust and assignment of rents may include a choice-of-law provision restricting the applicability of California law to the "creation, perfection, and enforcement" of the lien, so that the document drafter's intent would be for all other provisions of the deed of trust and assignment of rents and leases to be governed by the law of another state.

The opinion recipient's requirements may differ. The range of possibilities include (1) an assumption that all documents would be governed by California law and provide the standard opinion (which may be appropriate, because this would be the result if the choice of law of another state is not enforced in California); but, disclaiming any opinion regarding any specific document's reference to statutory or case law of other states; (2) an opinion restricted to the enforceability of only the California security documents, in which event a standard opinion with an assumption that the documents governed by the law of another state are enforceable in accordance with their terms and customary qualifications would be appropriate; or (3) an opinion that California courts would recognize the choice of the laws of the other state in the loan agreement and promissory note, in which event all factors relative to the recognition of a choice-of-law provision by a California court must be considered. It may also be that the opinion recipient is concerned with only a particular issue, *e.g.,* the effect of foreclosure in another state on the ability to enforce the California security documents, as opposed to which state's laws will govern the use of insurance proceeds for rebuilding.

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§8.61 1. Comprehensive Choice-of-Law Opinion

A comprehensive choice-of-law opinion (*i.e.,* that a California court would recognize and enforce the choice of the law of another state for all purposes) is not possible under California law. Existing case law mandates that the choice-of-law analysis be performed on each provision of a loan document. *Reich v Purcell* (1967) 67 C2d 551, 63 CR 31. The only particularly meaningful opinion would be one that focuses on a specific issue. This is not to suggest that a definitive answer may be provided by the opinion giver, but rather that the discussion in the qualification section can be more informative to the opinion recipient. Thus, even if a comprehensive choice-of-law opinion itself is not appropriate, a brief discussion of California jurisprudence on the subject, followed by a detailed discussion of the applicable law in the qualification section of the opinion, is proper. For a sample comprehensive choice-of-law opinion, see Alternative 2 in form 8.87-1.

On occasion, a recipient may request that the entire discussion of California jurisprudence be provided in the qualification section of the opinion rather than the opinion itself. For a sample short form choice-of-law opinion, which would require that the jurisprudential discussion from the comprehensive choice-of-law opinion be converted to a qualification, see Alternative 3 in form 8.87-1.

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§8.62 a. Use of Three-Prong Test

The comprehensive choice-of-law opinion should be followed by a somewhat lengthy discussion of the law regarding choice of law in California. The operative law has evolved over time into a flexible, and thus somewhat unpredictable, tool. The analysis is factually intensive and policy oriented. The paradigm of what should be described in the opinion as the "choice of law analysis" was established in *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330, which validated the proposition that, in general, parties to a multistate contract may, by so stipulating in their contract, choose the laws of one of the states with which the contract, the parties, or the transaction has a substantial relationship to govern their rights and obligations under the contract. *Nedlloyd* follows Restatement (Second) of Conflict of Laws §187 (1971) and provides a three-pronged analysis:

- Does the chosen state have a substantial relationship to the parties or the transaction, or is there any other reasonable basis for the selection of the chosen state? If not, the chosen state's law will not apply. If yes, the second prong is examined.
- Is the chosen state's law contrary to a fundamental policy of the State of California? If not, the chosen state's law will apply. If yes, the third prong is examined.
- Does the chosen state have a materially greater interest in seeing its law applied?

As more courts used this analysis, and as transactions became more complex and involved numerous states, it became apparent that the prongs must not be viewed in isolation—rather, they are interrelated. For example, the nature of the parties' relationship to the chosen state can affect the other tests; and because the essence of fundamentality is one of varying degrees, and some fundamental policies are more strongly held than others, the strength with which the policy is held will influence the other two prongs. See, *e.g., Guardian Sav. & Loan Ass'n v MD Assocs.* (1998) 64 CA4th 309, 75 CR2d 151, which involved the application of CCP §580b (clearly a fundamental public policy in California) when a Texas-based lender and an originally Texas-based borrower selected Texas law to govern a loan transaction secured by California property. A comparison of the substantiality of the contacts to California and Texas seemed to cause the court to validate the choice of Texas law on a "close" call.

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§8.63 b. Applicability and Limitations of Three-Prong Test

The three-prong test applies to each provision of the relevant documents. To provide a meaningful comprehensive opinion, each provision must be analyzed, which is generally a time-consuming, expensive, and, ultimately, not very rewarding exercise. Thus, no comprehensive opinion should be provided. Rather, a reasoned opinion may be provided on the first prong of the test, if the facts support such an opinion, that the chosen state has a substantial relationship to the parties or the transaction (including an analysis of the relevant contacts), or that there is otherwise a reasonable basis for the selection of the chosen state, followed by a short discussion of the other two prongs of the test, it being understood that the determination of the relationship or basis will be a factual one that may require an evidentiary hearing (*Mencor Enters., Inc. v Hets Equities Corp.* (1987) 190 CA3d 432, 235 CR 464). The qualification section of the opinion may include a more comprehensive discussion of the *Nedlloyd* test (*Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330) (see §8.62), the Restatement (Second) of Conflict of Laws §187 (1971), a discussion of fundamental policy, and the interests of the competing states. This discussion provides guidance to the opinion recipient regarding California choice-of-law analysis. Because of the particular difficulties in providing a choice-of-law opinion concerning the one-action and antideficiency laws, it is inappropriate to request such an opinion, and the opinion giver should specify in the opinion statement that no such opinion is provided. At best, a discussion of the relevant issues and authority may be provided in the qualification section, but it would be improper to provide a conclusion, other than perhaps on a discrete issue when there is proper case law guidance.

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§8.64 2. Single-Issue Choice-of-Law Opinion

The opinion recipient may have a particular concern that it asks to be addressed in the opinion. Issues that are occasionally addressed in a single issue choice-of-law opinion include the applicability of another state's usury law, the enforcement of an out-of-state deficiency judgment after a nonjudicial foreclosure sale of a California deed of trust, and the effect of an out-of-state enforcement action on the enforceability of a California loan document.

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§8.65 a. Usury

If the lender is an exempt lender or if the loan was arranged by a licensed California real estate broker, there is no real conflict issue, because the interest rate is enforceable under California law. Cal Const art XV, §1. The authors believe that in all other cases, because the public policy governing usury is comparatively weak in California, the opinion should not be difficult to provide. *Ury v Jewelers Acceptance Corp.* (1964) 227 CA2d 11, 38 CR 376. On usury, see §§3.37-3.44. For a sample usury choice-of-law opinion, see form 8.87-2.

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§8.66 b. Remedies

As a result of case law involving the enforceability of a deficiency judgment obtained in another state following a California nonjudicial foreclosure when the promissory note required application of Colorado law, an opinion on the enforceability of the deficiency judgment in California should not present a problem. *United Bank v K & W Trucking Co.* (1983) 147 CA3d 217, 195 CR 49, and its companion case, *Kerivan v Title Ins. & Trust Co.* (1983) 147 CA3d 225, 195 CR 53, held, for purposes of applying the "Full Faith and Credit" clause of the United States Constitution, that enforcement of a Colorado deficiency judgment following a nonjudicial foreclosure on California real property did not violate a fundamental California public policy, although such a deficiency judgment would have been prohibited under California's antideficiency laws.

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§8.66A 3. Incorporation by Reference of Documents Governed by Out-of-State Law

In transactions in which certain loan documents are governed by the laws of a state other than California, but the deed of trust is governed by California law, the provisions of the documents governed by other state's law often are incorporated by reference in the deed of trust. In this context, it is difficult to ascertain what law governs the enforceability of those provisions that are incorporated in the deed of trust. Would an opinion that the deed of trust is enforceable be considered an opinion that these provisions are enforceable under California law or under the other state's law? Is the opinion giver obligated to review the documents governed by the other state's law and consider their enforceability, and if so, under the law of what state?

This is an untenable position for the opinion giver. An opinion recipient should not expect an opinion on the enforceability of a document governed by the law of another state when it is the opinion recipient who created the document structure. This is not a choice-of-law opinion, *i.e.,* that the choice of the law of the other state to govern particular documents will be enforceable. Rather it is an opinion on enforceability of all substantive provisions in the documents structured to be governed by the law of a state other than California. The opinion giver should, therefore, include a specific qualification in the opinion disclaiming any opinion on the enforceability of any document governed by the law of a state other than California, or any provisions in such documents, that are incorporated by reference into a deed of trust governed by California law. These documents and provisions should be assumed to be enforceable, either in this qualification or elsewhere in the opinion, because the incorporated documents and provisions embody, at least in part, the obligations secured by the deed of trust. Without enforceable obligations secured by the deed of trust, the deed of trust would be worthless. See Paragraph 3.6.20 in form 8.84-1.

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§8.66B 4. Choice of Forum

Loan documents in multistate transactions often have a choice-of-forum clause that (1) allows the lender to bring any action involving the loan documents in a state other than California (or in the federal courts of a state other than California) and (2) requires the borrower's agreement to the lender's right to bring the action in that forum. Public policy issues implicated in the enforceability of this provision by a California court are the same as those discussed in §8.66A. See also *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 131 CR 374, which held that a forum selection clause was subject to a reasonableness test and that the fact that many of the witnesses were located in California did not mean that a clause mandating that an action be brought in Pennsylvania would be unreasonable or violate public policy. A qualification citing to this case and the test to be followed should be included in the opinion. For sample choice-of-forum qualifications, see Paragraph 3.5.2 in form 8.83-1 and Paragraph 3.6.17 in form 8.84-1.

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§8.67 I. Opinions Relating to Collateral

The principal source of repayment of a real estate secured loan is the real and personal property collateral for the loan. It is therefore not surprising that an opinion recipient may seek assurances from an opinion giver concerning the collateral and the liens encumbering the collateral. Commentators and bar reports question the propriety of opinion requests of this sort because the legal conclusions that they generally contain are of limited value and rest on facts that must all be assumed. Opinions on collateral and liens on collateral tend to be drafting exercises for the opinion giver rather than the application of legal judgment to facts more readily available to the giver than to the opinion recipient. Nonetheless, such opinions are requested and the opinion giver as well as counsel for the opinion recipient must negotiate a response to the request.

The common types of opinions relating to collateral are as follows:

- For real property collateral:
- Real property lien perfection opinion (see §§8.68-8.70);
- Form of documents opinion (see §8.71); and
- Land use opinion (see §8.72);
- For leases and rents collateral:
- Leases and rents security interest perfection opinion (see §8.72A)
- For personal property collateral (see §8.73):
- Personal property security interest perfection opinion (see §8.74); and
- Personal property security interest priority opinion (see §8.75).

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1. Opinions on Real Property Collateral

§8.68 a. Perfection of Real Property Liens

It is unusual for a California law firm to ask for any opinions on the creation, perfection, or priority of California real property liens, at least when the firm is representing an opinion recipient with a presence in California. A borrower pays for a policy of insurance insuring the creation, perfection, and priority of the lender's real property lien, which is more than anyone can reasonably expect a California lawyer to do. Indeed, the opinion reports and commentators recommend that an opinion giver disclaim any opinion on title to real property or the perfection or priority of the mortgage or deed of trust lien, especially if an opinion is being rendered on the enforceability of the mortgage or deed of trust. But see ABA-ACREL Guidelines §4.0.c, which states that there is no need to disclaim an opinion on title. See Paragraphs 2.5 and 2.5.1 (Alternatives 1-3) in form 8.78-1.

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§8.69 (1) Limited Perfection Opinions

Out-of-state lenders and their counsel frequently request California counsel to render limited opinions on the form of the California deed of trust and the steps necessary to perfect the lien created by it. These requests are common in multistate transactions, in which the opinion giver is often acting as a local California counsel in a transaction being managed from another state. The opinion recipient and its counsel are seeking assurances that their standard, multistate forms work in California to create a lien and that their steps to put third parties on notice of the real property lien are correct. The opinion request itself may identify problems with the form of the deed of trust prior to the closing, and sometimes even before the date on which the title insurance company has an opportunity to review the documents.

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§8.70 (2) Contents of Lien Perfection Opinion

The real property lien perfection opinion is a description of the steps necessary to establish the priority of the lien over competing creditors. The opinion may take the form of a statement that, on the recordation and proper indexing of the deed of trust in the county in the State of California in which the real property described in the deed of trust is located, the deed of trust will provide constructive notice of the lien of the deed of trust under the California recording acts (CC §§1169-1220).

Note that the recording acts in California do not speak of the "perfection" of the lien, but the "constructive notice" imparted by recordation. They also state that a conveyance that is later recorded is void against a conveyance that was recorded earlier in good faith and for valuable consideration. CC §§1213-1214. If the opinion recipient requires the opinion giver to describe the effect of recordation of the lien, the opinion will usually either simply state that recordation provides constructive notice of its contents, or give priority of the recorded lien over all later-recorded conveyances, assuming that when the lien was recorded, the lienholder gave valuable consideration for the lien, acted in good faith in taking the lien, and had no notice—actual, constructive, or inquiry—of any earlier conveyance that might be later recorded.

Opinions on the effect of the recording acts assume that the legal description is adequate, that the grantor of the lien has an interest in the property described, and that the grantor's interest is properly of record (*i.e.,* within the chain of title).

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§8.71 b. Form of Documents Opinion

The real property lien perfection opinion is often coupled with an opinion that the mortgage or deed of trust "is in a form sufficient to create a lien" on the real property in favor of the lender (opinion recipient). See *Legal Opinions in California Real Estate Transactions*, 42 Bus Law 1139, 1185 (1987); ABA-ACREL Guidelines §4.0.c. Like the lien perfection opinion, the form of documents opinion is both easy to give and of little value, because title insurance assures the lender that the mortgage or deed of trust is in proper form.

Also, as in a lien perfection opinion, the opinion giver must include express disclaimers about what the form of documents opinion does not cover. The form of documents opinion is not a form of enforceability opinion, and this should be made express, especially if the opinion recipient is not asking for an enforceability opinion and no exceptions to enforceability are being listed in the opinion letter. The opinion letter should also make clear that the form of documents opinion is not an opinion about the existence of a lien on a particular property or the adequacy or accuracy of the legal description of the property. A form of documents opinion, standing alone, need not assume the proper recordation of the mortgage or deed of trust, because recordation is not a prerequisite to the creation of a lien.

PRACTICE TIP: Typical issues that arise in this context relate to the size of a document's margins and borders (as required by the local recorder) and the form of notary acknowledgment. If there is an error on the cover page (for example, inadequate space for the recording information), the recorder's office will usually simply add a compliant cover page, but in order to avoid the risk of "bounced" documents, legal counsel responsible for recording the documents should check carefully to make sure that they are in general compliance with the recorder's requirements.

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§8.72 c. Environmental and Land Use Opinion

A multitude of laws, rules, and regulations govern the use and development of real property. A lender making a loan on the basis of the value of the real property has a legitimate interest that its collateral complies with the laws, rules, and regulations relating to construction, zoning, subdivision, environmental impact, and hazardous substances. The main issue is whether the legal opinion is an appropriate means of satisfying the lender's concerns in these areas. From the perspective of the commentators and bar reports, the answer, for three reasons, is no:

- There are nonlawyer specialists who have the training and experience to give the lender the assurances in these areas;
- Lawyers lack the training to gather and analyze the facts, take the measurements, and review and apply the relevant mass of statutes, rules, and regulations necessary to render the opinions that would be of value to the lender; and
- Legal opinions on land use or environmental issues that rely solely on the work of specialists or governmental permits, licenses, or certificates to support their conclusions add nothing to the things on which they rely, yet they run the risk of creating in the opinion recipient a contrary expectation.

California has a fourth reason—the availability of title company products, such as zoning endorsements, that can provide the lender with needed assurances. See California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997).

Although architects, engineers, and environmental specialists are not lawyers, they are in the business of shepherding their clients' projects through the appropriate administrative processes and of making certain that the projects comply with the requirements of laws, rules, and regulations applicable to their construction and operation. These specialists may not be trained to parse the wording of a statute or regulation, but they are trained to make the measurements and ascertain the facts called for by the statute or regulation.

Legal training equips the lawyer to analyze ambiguities in the language of a land use or environmental statute, rule, or regulation, but not to analyze the facts or make the measurements that the statute, rule, or regulation requires someone to analyze or make. The existence of nonlawyer specialists in the land use and environmental fields has meant that, except for those whose practices are focused in these areas, lawyers have little knowledge of the sources of the relevant land use and environmental statutes, rules, and regulations, let alone any familiarity with their content. For most lawyers, a land use or environmental opinion would not only have to assume all or almost all facts, it would also have to limit the statutes, rules, and regulations on which the opinion is based. Even with such limitations, the opinion giver must engage in extensive factual and legal research to render an opinion of little value, if only because the opinion covers areas that are likely to be beyond the giver's expertise.

A lawyer may be able to render an opinion that a particular property complies with the relevant zoning and building codes and other land use laws and regulations if the opinion is based solely on the issuance of a certificate of occupancy or confirming letters from appropriate governmental officials. Other opinions on compliance with land use and environmental laws may be rendered if based solely on a certificate of a specialist like an architect, or a report rendered by an environmental specialist. If properly written to take into account the limited due diligence that the lawyer is able to conduct in a cost-effective manner and the lawyer's lack of qualification to judge whether the statements made in the certificates or reports are correct or whether the permits were properly issued, land use and environmental compliance opinions can be rendered, but they add nothing to the certificates and reports on which they are based.

An attorney who does render such an opinion runs the risk that, if an issue about the opinion arises months or even years after the opinion is rendered, the opinion recipient may argue that the opinion has a meaning that goes beyond the certificates and reports on which it is based; *e.g.,* that the opinion giver is somehow validating the certificates and reports. The counter to this argument may be an accurate description of what the opinion was intended to say (*i.e.,* nothing of value), but in the world of litigation, the argument that a lawyer's words were intended to have no meaning of any worth rings hollow.

ABA-ACREL Guidelines §4.3.a takes the position that land use and environmental opinions are not customary, because "they involve complex, technical matters that are not easily, or sometimes at all, susceptible to separation into factual and legal components."

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§8.72A 2. Opinions on Leases and Rents Collateral

Generally, a typical deed of trust and an assignment of leases and rents each grants a security interest in all leases, rents, and related collateral, although they are often denominated as an "absolute assignment." See discussion in §8.24. Civil Code §2938(a) provides for the effectiveness of a lien on existing and future leases, rents, issues, or profits of that real property, and includes the cash proceeds of such items. The opinion may be similar to one provided specifically with respect to the deed of trust. If there is no separate assignment of leases and rents document, see Paragraph 2.5.1 (Alternative 1) in form 8.78-1. If there is a separate assignment of leases and rents document, see Paragraph 2.5.1 (Alternative 2) in form 8.78-1.

PRACTICE TIP: Practitioners should note that "leases, rents, issues, or profits" are not defined in CC §2938, so certain items of collateral in which a security interest is created by a broad assignment provision (such as in a standard deed of trust or assignment of leases and rents agreement) may not be covered by the statute. A qualification to the opinion noting that these other items of collateral will be subject to all of the assumptions and qualifications concerning the California Commercial Code is appropriate. See §7.10; Paragraph 3.7.5.1 in form 8.85-1.

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§8.73 3. Opinions on Personal Property Collateral

The typical deed of trust encumbers not only real property and fixtures, but the borrower's personal property relating to the real property. On deeds of trust, see chap 4. The significance of the personal property in the transaction varies with the type of property. If it is an office building, the personal property may be of relatively minor significance, but if the loan is being secured by an operating hotel, the personal property, the furniture, furnishings, and equipment may represent a material part of the value of the lender's security. Even intellectual property and corporate stock may play a role in a real estate secured transaction.

When personal property forms a material part of the collateral value in a real property secured transaction, an opinion recipient may require assurance that the appropriate steps are taken to perfect the lender's security interest in the borrower's personal property. With a title insurance policy, the opinion recipient receives this assurance for the real property, although, as noted in §8.69, out-of-state lenders may request assurance on the manner of creating a first priority lien on California real property collateral. Title insurance is also becoming more common when personal property is a significant portion of the overall collateral package to insure (with various exceptions) the perfection and priority of lender's security interest in personal property. Perfection and priority of liens in personal property collateral are governed by the intricacies of the Uniform Commercial Code, as in effect both in California and other states with a connection to the transaction (in particular, the borrower's state of organization). See §§7.21-7.45.

Revised Article 9 of the Uniform Commercial Code has been enacted in California (Division 9 of the California Commercial Code, effective July 1, 2001) and in every other state, with limited nonuniform revisions. (All references in this chapter to Division 9 are to the California adoption of revised UCC Article 9.) As a result, in most real estate transactions, especially when there is limited personal property collateral, it would be presumptuous for an out-of-state lender to request anything other than a very limited opinion with respect to personal property collateral, if any opinion is appropriate at all. Paragraph 2.5 in form 8.78-1 provides that the form of the security documents is sufficient to create a security interest on all collateral, including personal property collateral, if a security interest can be created in such collateral under Division 9.

NOTE: In light of the unanimous national enactment of revised UCC Article 9, a request for this opinion, with no local issues addressed, and limited to whatever revised UCC Article 9 permits, is of questionable value because it does nothing more than state the obvious.

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a. Perfection Opinions for Personal Property Collateral

§8.74 (1) Requirements for Perfection; Impact on Opinion

As a result of the enactment of Division 9 in California with its express incorporation of the law of another state concerning perfection issues, the opinion giver must confront different issues than previously existed if a perfection opinion is requested. Many lenders in real estate secured loan transactions have retreated from the previous standard opinion request.

Security interests in different types of personal property are perfected in different ways. See chap 7.

- In deposit accounts, letter of credit rights, and other similar items of personal property, it is perfected by "control." Com C §§9104(a)-(b), 9314(a)-(b).
- In certain collateral, such as instruments, it is perfected by either possession or the filing of a financing statement. Com C §§9102(a)(47), 9312(a).
- In personal property most typically associated with real property collateral, such as equipment, furnishings, and general intangibles, it is perfected, as in the past, by a filing a financing statement. Com C §§9102(a)(42), 9310(a).

The primary difference between the perfection requirements under old Division 9 and revised Division 9 is that perfection is governed by the law of the state where the borrower is located, *i.e.,* the state of the borrower's organization for those borrowing entities created by a filing with a state. Com C §9301(1); Com C §9307. Most states have central filing with the Secretary of State, but some do not. If (1) a borrower is located in a state other than California, (2) the security agreement is governed by California law, and (3) the California Commercial Code provides for perfection in accordance with the local laws of a state other than California, then it is arguably inappropriate for a California practitioner to render a perfection opinion. In this situation the only appropriate opinion would be a statement about which state's law governs perfection. If the opinion giver assumes that the state law governing perfection provides for perfection by filing, then the opinion giver could expand the opinion to provide that, to perfect a personal property security interest that is perfected by filing, the proper place to file the UCC-1 is with the appropriate filing officer in the state whose law governs perfection. This opinion advises the opinion recipient that California law is consistent with revised UCC Article 9 with respect to perfection of security interests in personal property items that can be perfected by a filing. See form 8.78-1, Paragraph 2.6.

NOTE: For further information concerning UCC opinions, see *Special Report of the Tri-Bar Opinion Committee: U.C.C. Security Interest Opinions—Revised Article 9*, 58 Bus Law 1449 (Aug. 2003). The Tri-Bar Opinion Committee consists of New York City, County and State Bar Associations or Committees, along with members from other cities). Additionally, the Uniform Commercial Code Committee of the Business Law Section of the State Bar of California has published Report of the Uniform Commercial Code Committee of the Business Law Section of the State Bar of California on Legal Opinions in Personal Property Secured Transactions, June 2005 (Personal Property Opinion Report). The Report can be obtained from the State Bar website. (See Directory.) Each of these sources should be consulted regarding the scope of the perfection opinion and the necessity for including particular assumptions and qualifications.

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§8.74A (2) Contents of Perfection Opinion

If the proper place of filing is California (*i.e.,* the borrower is located in California) or if the practitioner is willing to opine on a filing in another state (*i.e.,* the borrower is not located in California), *and* if a more elaborate perfection opinion is requested, then the typical perfection opinion will combine assumptions with a restatement of the perfection requirements for a security interest under the Uniform Commercial Code that forms a perfect circle. The opinion would rarely cover more than personal property that can be perfected by filing in the state of the borrower's location, and it assumes not only the fact of a proper filing, but the existence of the property described, the accuracy of the description, the borrower's interest in it, and even the giving of value by the lender. In essence, the opinion sets out the steps necessary to perfect by filing, and states that, if these steps are taken and the assumptions are true, perfection has occurred (or will occur), but only for collateral that can be perfected by filing. The limited scope of the perfection opinion and its tautological nature call into question its value to the opinion recipient. For the opinion giver, the perfection opinion is little more than crafting an airtight description of the UCC provisions.

There are a number of qualifications to the perfection opinion that need to be considered that relate to events that occur after perfection, the effect of perfection or nonperfection, and limitations to perfection concerning certain types of collateral, such as tort claims and intellectual property. If the opinion giver is providing an opinion on perfection governed by the law of another state, the qualifications should be consistent with the law of that state.

The opinion recipient may also desire more than simply an opinion that essentially tells the recipient where to file a UCC-1 Financing Statement. The opinion recipient may want an opinion on how to perfect a security interest in all collateral described in the trust deed and security agreement. In addition to considering the issues related to the laws of another state that may govern perfection of security interests in certain items of personal property, an opinion of this type is little more than an extension of the opinion described above, though with many more assumptions and a much more elaborate description of procedures. The utility of such an opinion is questionable. Unless the UCC experts in the opinion giver's firm have prepared, and kept up to date, a form of omnibus perfection opinion, it will be a costly and time-consuming undertaking, particularly when the laws of another state govern perfection. It is beyond the scope of this book to discuss in detail the nuances of such a comprehensive, though marginally useful, opinion. For relevant discussion, see the Personal Property Opinion Report, which largely did the work for California lawyers for this opinion.

As a result of the enactment of revised UCC Article 9 in a state other than California whose law governs a particular loan transaction, an opinion giver in that other state may not give a requested unqualified perfection opinion if the loan documents select the law of that state to govern the various documents and the borrower is located in California. Under such circumstances, a California lawyer may become the opinion giver for this opinion. The California opinion giver would assume that (1) the law of the other state provides that the law of the location of the borrower governs perfection and (2) the location is determined by a filing in California by the borrower. The opinion would then cover only a security interest in personal property that can be perfected by filing, but would include all of the assumptions described above, as well as assumptions concerning the creation of the security interest under the law of another state, again, rendering the opinion of questionable value. See Paragraph 2.6, Alternative 3, in form 8.78-1.

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b. Priority Opinions for Personal Property Collateral

§8.75 (1) Limited Utility of Priority Opinion

Lenders and their counsel may ask not only for a perfection opinion, but for an opinion that, on its being perfected, the lender's security interest will have priority over all others with an interest in the collateral, whether that interest arises before or after the perfection of the lender's security interest. Requests for priority opinions are less common than perfection opinions, and all who have addressed the subject have concluded that lawyers are not in a position to render an opinion of any value on priority. See, *e.g.,* the Personal Property Opinion Report at 54.

NOTE: Priority issues with respect to property, such as goods, are governed by the law of the state in which the goods are located (see Com C §9301), as opposed to perfection issues, which are governed by the law of the state of the borrower's location (see Com C §§9301(1), 9307, 9501). Priority issues with respect to general intangibles are governed by the law of the state of the borrower's location. See Com C §9301. Not only does any opinion regarding priority issues, therefore, raise many of the same issues and concerns as perfection opinions, but the practitioner must be careful to define which elements of personal property collateral are to be included in the opinion. This is another reason for the opinion giver to reject a request for a priority opinion.

The circumstances in which a security interest in a particular type of personal property collateral will have priority over third party interests depends on the type of collateral and whether the UCC governs the priority of the lien on that type of collateral. The specific rules are covered in the Personal Property Opinion Report. It is sufficient to note the conclusion of this report, which states that "these opinions rarely justify the additional cost to the parties of their preparation, review and negotiation [and] should generally not be requested in secured transactions involving personal property." Personal Property Opinion Report at 55.

PRACTICE TIP: As noted in §8.73, title insurance companies are marketing a product insuring perfection and priority of security interests in personal property. As pricing adjusts to the marketplace for real estate transactions, requests for priority opinions, to the extent they are not already, should be a thing of the past.

A clear example of the lack of utility of a priority opinion is a priority opinion in collateral perfected by filing. The most an opinion giver can say is that if the lender has a perfected security interest in certain defined items of collateral with reference to the various subsections of Com C §9301, that interest will be prior to any other security interest in such collateral that can be perfected solely by filing a financing statement under California law, with respect to priority issues governed by California law, and under the applicable law of any other state with respect to priority issues governed by such other state's law. (Assuming, of course, that a California lawyer will provide an opinion with respect to the law of another state.)

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§8.75A (2) Scope of Priority Opinion

There are various types of limited priority opinions, including those concerning filing priority, priority based on possession or control, and special protection against adverse claims by the purchaser of a certificated security or security entitlement. See Personal Property Opinion Report at 55. If a filing-priority opinion is given, the opinion giver should list the following as exceptions to the opinion:

- Security interests disclosed by specific UCC reports issued by the California Secretary of State (if the borrower is located in California or, if not, if the personal property is located in California and may have been perfected by the filing of a UCC-1 in California under former Division 9) and the comparable filing office in the state in which the borrower is located (if the borrower is located in a state other than California, and again assuming a California lawyer is willing to provide an opinion with respect to the law of another state); and
- Any other interests about which the lender knew or should have known at the time of filing.

Further, the opinion giver should include the assumption that the reports are accurate (although, as with other certificates, the time delay in receiving one means that the information is not current). Because the opinion is limited to priority over persons whose interests can be perfected by filing under the UCC, it is therefore little more than a conduit opinion for the UCC report.

Because of the enactment of revised UCC Article 9 in a state other than California whose law governs a particular loan transaction, counsel in such other state may not give a requested priority opinion if

- certain items of the collateral, such as goods, are located in California; or
- the borrower is located in California and an opinion is requested concerning certain items of collateral, such as general intangibles.

In each such situation, California law will govern priority issues, assuming that revised UCC Article 9 in the state whose law governs the transaction is identical to Division 9 of the California Commercial Code. Once again a complex web of assumptions, as well as consideration of the revised UCC Article 9 and revised Division 9 transition rules, would be necessary to provide this generally useless opinion.

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VIII. INCLUSIVE REAL ESTATE SECURED TRANSACTION OPINION FORM

§8.76 A. Form: Introduction

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.76-8.90.

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

NOTE: The legal opinion in §§8.76-8.90 is adapted from the Inclusive Real Estate Secured Transaction Opinion in Which Are Incorporated the Principal Concepts of the ABA Section of Business Law Legal Opinion Accord and the ABA Section of Real Property, Probate and Trust Law and The American College of Real Estate Lawyers Report on Adaptation of the Legal Opinion Accord—A Report of the Joint ABA/ACREL Committee Comprising: The American Bar Association, Section of Real Property, Probate and Trust Law, Committee on Legal Opinions in Real Estate Transactions, Subcommittee on Creation of an Inclusive Opinion and The American College of Real Estate Lawyers Attorneys' Opinions Committee. The ABA/ACREL opinion has been modified and supplemented by the authors. The ABA/ACREL opinion is published on the website of, and is copyrighted by, the American Bar Association. The commentary is published on the ACREL website. All rights reserved. Reprinted by permission. See Directory for more information.

8.76-1 Introduction

_ _[*Date*]_ _
_ _[*Name*]_ _
_ _[*Address of opinion recipient*]_ _
Re: _ _[*Dollar amount*]_ _ Loan (Transaction) from _ _[*name of lender*]_ _ (Lender) to _ _[*name of client*]_ _ (Client)

Ladies and Gentlemen:

We provide this Opinion Letter to you at the request of the above-named Client under Section _ _[*number*]_ _ of the Agreement described in _ _[*e.g., Paragraph 1.1.5*]_ _ below.

Comment: The client must consent to the rendering of the opinion letter. Consent may be implied by the client's execution of a transaction document that requires an opinion letter. See Certain Guidelines for the Negotiation and Preparation of Third-Party Legal Opinions Following the Accord, Part II, F. See also §8.13.

For defined terms used in this opinion letter, see the Glossary in §8.90.

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§8.77 B. Form: Background

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8.77-1 Background

1. Background.

1.1. Documents Reviewed. We have acted as _ _[*describe limited or special role, if appropriate*]_ _ counsel to the Client in connection with the preparation of the following documents relating to the Transaction:

1.1.1. Promissory Note dated _ _[*date*]_ _, made by the Client (the Note).

1.1.2. Deed of Trust dated _ _[*date*]_ _, executed by the Client (the Deed of Trust) regarding certain real property located at _ _[*address*]_ _ (the Real Property).

1.1.3. Assignment of Leases and Rents dated _ _[*date*]_ _, executed by the Client (the Assignment of Leases).

1.1.4. Security Agreement dated _ _[*date*]_ _, executed by the Client (the Security Agreement).

1.1.5. Loan Agreement dated _ _[*date*]_ _, executed by the Client and Lender (the Agreement).

1.1.6. _ _[*E.g., Two*]_ _ _ _[*if appropriate, add unfiled*]_ _ Uniform Commercial Code Financing Statements naming the Client as debtor (the Financing Statements).

1.2. Transaction Documents. The documents described in items _ _[*e.g., 1.1.1 through 1.1.5*]_ _ are referred to in this Opinion Letter as the "Transaction Documents." The documents described in Paragraphs _ _[*e.g., 1.1.2 through 1.1.4*]_ _ are referred to in this Opinion Letter as the "Security Documents." All property described in any of the Security Documents in respect of which provision is made by the Security Documents for a lien or security interest is referred to in this Opinion Letter as the "Collateral." Except as otherwise indicated in this Opinion Letter, the capitalized terms are defined as set forth in the Glossary attached to this Opinion Letter or in the Agreement.

1.3. Opining Jurisdiction. The Law (as defined in the attached Glossary) covered by the opinions expressed in this Opinion Letter is limited to the Law of the State of _ _[*name of state*]_ _ (the State)

[*If appropriate, add*]

and the General Corporation Law of the State of Delaware.

Except as set forth in _ _[*e.g., Paragraphs 2.1 and 2.2*]_ _, we express no opinion on the laws of any other jurisdiction,

[*If appropriate, add*]

the other Laws of the State of Delaware,

[*Continue*]

or the effect of _ _[*those laws/that law*]_ _.

1.4. Scope of Review. In connection with the opinions in this Opinion Letter, we have limited the scope of our review of the documents related to the Transaction to _ _[*e.g., originals/photocopies of*]_ _ the Transaction Documents and the Financing Statements. In addition, in connection with the opinions in this Opinion Letter, we have reviewed such other documents and certificates of public officials and certificates of representatives of the Client, and have considered such matters of law and fact, as we have deemed appropriate, in our professional judgment, to render such opinions.

1.5. Reliance Without Investigation. We have relied, without investigation or analysis, on information in Public Authority Documents (as defined in the attached Glossary). Except to the extent the information constitutes a statement, directly or in practical effect, of any legal conclusion at issue, we have relied, without investigation or analysis, on the information in representations made by the Client in _ _[*Sections* _ _]_ _ of the Agreement and on information provided _ _[*by officials*/*in certificates of officers*]_ _ of the Client, which we reasonably believe, in each instance, to be a proper source for the information. Unless the information constitutes a statement, directly or in practical effect, of any legal conclusion at issue, we have relied, without investigation or analysis, on information provided to us by Lender, as set forth in _ _[*specify*]_ _.

[*If appropriate, add*]

1.6. Opinions of Other Counsel. We note that various issues concerning _ _[*specify legal issues*]_ _ are addressed in the opinion of _ _[*name*]_ _ (the Other Counsel), separately provided to Lender. _ _[*In rendering the opinions set forth below, we have relied on the information in such opinion of the Other Counsel without investigation or analysis, and we express no opinion on those matters.*]_ _

Comment: Counsel giving the opinion often acts in a limited or special role, which usually involves providing an opinion as local counsel but does not otherwise involve negotiating the transaction. Under such circumstances, it is common for the opinion giver to state such limited involvement. See Paragraph 1.1.

Paragraph 1.1 also contains examples of common real estate loan transaction documents. This form opines on the enforceability only of specifically identified transaction documents (see Paragraph 1.4). Counsel should add to this list in Paragraph 1.1 any other operative documents for the transaction; conform the document names in the list to the actual names of the documents; and create other defined terms as needed. If a guaranty is one of the transaction documents, counsel must also consider the particular issues raised, and any additional qualifications that would be appropriate.

The term "Security Documents" in Paragraph 1.2 should include all documents that provide for the creation of a lien or security interest to secure the client's obligations under the transaction documents.

If the client is a corporation formed other than in the "State," the corporate laws of its state of formation should be put into Paragraph 1.3. Under Accord §10(c), coverage of the law in which the client exists is implicit in a remedies opinion. The laws of other jurisdictions may also be included. For example, the "Federal Law of the United States" may be added. Because the "Opining Jurisdiction" defined in the Glossary in §8.90 can include more than one jurisdiction, this form introduces the term "State"; if only one jurisdiction is involved, the term "Opining Jurisdiction" can replace "State." See Accord §§1, 10, 22.

Accord §2 and its accompanying Commentary permit the opinion giver to limit the scope of inquiry to specific documents, but only if the limitation is explicit, as it is in Paragraph 1.4. Some opinion givers prefer to identify each document reviewed and disclaim any factual inquiry beyond the identified documents.

See Accord §3 and the accompanying Commentary for permissible reliance on information provided by others. Counsel should consider specifying in Paragraph 1.5 the public authority documents, client certificates, and other documents to be relied on in rendering the opinion.

Accord §8 describes the relationship of the opinion giver with other counsel giving opinions in the same transaction. This description is rather complex. Counsel should carefully consider the appropriate level of assurance to be given by an opinion giver on the legal opinions of other counsel. See Paragraph 1.6.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/8 The Legal Opinion/§8.78 C. Form: Opinions

§8.78 C. Form: Opinions

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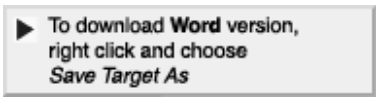

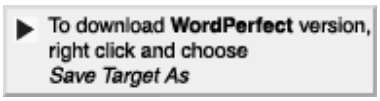

8.78-1 Opinions

2. Opinions. Based on and subject to the foregoing and to the qualifications set forth below, we are of the opinion that:

[*Add one of the following two alternatives*]

[*Alternative 1: Basic status opinion*]

2.1. Status. The Client is a _ _[*e.g., limited liability company*]_ _, validly existing in good standing in the jurisdiction of its organization,

[*Alternative 2: Status opinion relying on good standing certificate*]

2.1. Status. The Client is a _ _[*e.g., limited liability company*]_ _, and based solely on the _ _[*describe good standing certificate, including date*]_ _, is validly existing in good standing in the jurisdiction of its organization,

[*Option: Add if client is a foreign corporation in the state*]

and the Client is also "qualified to do business in the State."

[*Continue*]

2.2. Authorization. All actions or approvals by the Client, and its _ _[*members*]_ _, necessary to bind the Client under the Transaction Documents have been taken or obtained.

2.3. Execution. The Client has duly executed and delivered the Transaction Documents for valid consideration.

[*Add one of the following three alternatives*]

[*Alternative 1: Basic remedies opinion*]

2.4. Remedies Opinion. The Transaction Documents are legal, valid, binding, and enforceable against the Client in accordance with their respective terms.

[*Add the following if an opinion is required on a guaranty or other suretyship agreement, and exclude the guaranty or other suretyship agreement from the remedies opinion on transaction documents*]

The Guaranty is legal, valid, binding, and enforceable in accordance with its terms.

[*Alternative 2: Transaction documents split choice of law between opining jurisdiction and other jurisdictions*]

2.4. Remedies Opinion. The provisions of the Transaction Documents that are to be governed by the Law of the State pursuant to _ _[*Section _ _*]_ _ of the Agreement are legal, valid, binding, and enforceable against the Client in accordance with their respective terms.

[*Alternative 3: Transaction documents prescribe arbitration*]

2.4. Remedies Opinion. The provisions of the Transaction Documents that are to be governed by the Law of the State pursuant to _ _[*Section _ _*]_ _ of the Agreement are legal, valid, binding, and enforceable against the Client in accordance with their respective terms. This paragraph includes an opinion that a court will give effect to an agreement in the Transaction Documents to arbitrate disputes, but it does not indicate how the arbitration will deal with any dispute under the contract formed by the Transaction Documents.

[*If applicable, add the following option to anyone of the foregoing three alternatives*]

[*Option: Effectiveness of remedy*]

That is, under the law of contracts of the Opining Jurisdiction, and other laws of the Opining Jurisdiction that

we, in the exercise of customary professional diligence would reasonably recognize as being directly applicable to the Client, the Transaction, or both: the Transaction Documents form a contract; a remedy will be available for each agreement of the Client in the Transaction Documents or such agreement will otherwise be given effect; and any remedy expressly provided for in the Transaction Documents will be given effect as stated.

[*Continue*]

2.5. Form of Security Documents. The Security Documents are in a form sufficient to create a lien on or security interest in all right, title, and interest of the Client in the Collateral, except to the extent the Collateral includes items or types of Personal Property (as defined in the attached Glossary) in which a security interest cannot be created under Article 9 of the Uniform Commercial Code.

[*If there is a request for a lien and perfection opinion on Deed of Trust and/or Assignment of Leases and Rents, add one of the following alternatives*]

[*Alternative 1: Deed of Trust only*]

2.5.1. Deed of Trust. The Deed of Trust is in sufficient form for recording in the Official Records of the Office of the County Recorder of _ _[*name of county*]_ _, State of California (the "Recording Office"). When the Deed of Trust is duly executed and delivered, the Deed of Trust will be sufficient to create a lien for the benefit of Lender, and following recordation and indexing of the Deed of Trust, sufficient to give constructive notice to third parties of the lien of the Deed of Trust, on that portion of the property described in the Deed of Trust that constitutes real property.

[*Alternative 2: Deed of Trust with assignment of leases and rents*]

2.5.1. Deed of Trust. The Deed of Trust is in form sufficient, following its execution and delivery, to create a security interest for the benefit of Lender on the "leases," "rents," "issues," and "profits," as such terms are used in California Civil Code Section 2938 (collectively, the "Rents"), to the extent the Rents are assigned in the Deed of Trust and, following recordation and indexing of the Deed of Trust, to perfect such security interest and give constructive notice to third parties of such security interest in the Rents, to the extent the Rents are assigned in the Deed of Trust.

[*Alternative 3: Separate assignment of leases and rents*]

2.5.1. Assignment of Leases. The Assignment of Leases is in proper form for recording in the Recording Office. The Assignment of Leases is in proper form sufficient, following its execution and delivery to create a security interest for the benefit of Lender on the "leases," "rents," "issues," and "profits," as such terms are used in California Civil Code Section 2938 (collectively, the "Rents"), to the extent the Rents are assigned in the Assignment of Leases, and, following recordation and indexing of the Assignment of Leases, to give constructive notice to third parties of such security interest in the Rents, to the extent the Rents are assigned in the Assignment of Leases.

[*Continue*]

[*Add one of the following three alternatives*]

[*Alternative 1: Client Not Located in California—California Law Governs Security Documents*]

2.6. Perfection of Personal Property Security Interest. Under applicable California law, the local law of the jurisdiction where the Client is located governs perfection of the Lender's security interest in personal property described in the Security Documents that is subject to Division 9 of the California Commercial Code (Article 9 Collateral) except to the extent otherwise provided in California Commercial Code §§9301(2), (3)(A)-(B), (4), and 9303-9306. Based on _ _[*the assumption/the fact*]_ _ that the Client is a registered organization organized under the laws of the State of _ _[*name of state*]_ _, the law of that State will govern perfection of Lender's security interest in the Article 9 Collateral except to the extent otherwise provided in California Commercial Code §§9301(2), (3)(A)-(B), (4), and 9303-9306.

[*Add one of the following two alternatives to Alternative 1, if required by opinion recipient*]

[*Alternative A: Article 9 adopted in state where client is located is same as Division 9 of California Commercial Code*]

Assuming that the provisions of Article 9 of the version of the Uniform Commercial Code adopted in the State of _ _[*name of state*]_ _ are identical to the provisions of Division 9 of the California Commercial Code, on the filing of the UCC-1 with the appropriate Uniform Commercial Code filing office in the State of _ _[*name of state*]_ _, Lender's security interest in the Article 9 Collateral, except to the extent otherwise provided in California Commercial Code §§9301(2), (3)(A)-(B), (4), and 9303-9306, that can be perfected solely by such a filing will be perfected. This opinion is specifically subject to the effect of the various requirements in the California Commercial Code regarding the maintenance of valid and perfected security interests and events occurring after the date of this opinion letter.

[*Alternative B: Article 9 as adopted in state where client is located*]

On the filing of the UCC-1 with the appropriate Uniform Commercial Code filing office in the State of _ _[*name of state*]_ _, Lender's security interest in the Article 9 Collateral, except to the extent otherwise provided in California Commercial Code §§9301(2), (3)(A)-(B), (4), and 9303-9306, that can be perfected solely by such a filing will be perfected. Although we are not admitted to practice in the State of _ _[*name of state*]_ _ and have not obtained opinions of counsel admitted in such jurisdiction with respect to the perfection or the continued perfection of the security interests in personal property created by the Security Instrument, we have examined the applicable provisions of Article 9 of the _ _[*name of state*]_ _ UCC, in each case, as those provisions appear in unofficial compilations thereof, and our opinions, to the extent they involve conclusions about perfection of such security interests under the laws of the State of _ _[*name of state*]_ _, are based solely upon such review.

[*Continue*]

[*Alternative 2: Client Located in California—California Law Governs Security Documents*]

2.6. Perfection of Personal Property Security Interest. Under applicable California law, the local law of the jurisdiction where the Client is located governs perfection of the Lender's security interest in personal property described in the Security Documents that is subject to Division 9 of the California Commercial Code (Article 9 Collateral) except to the extent otherwise provided in California Commercial Code §§9301(2), (3)(A)-(B), (4), and 9303-9306. Because the Client is a registered organization organized under the laws of the State of California, on the filing of the UCC-1 with the California Secretary of State, Lender's security interest in Article 9 Collateral, except to the extent otherwise provided in California Commercial Code §§9301(2), (3)(A)-(B), (4), and 9303-9306, that can be perfected by such a filing will be perfected. This opinion is specifically subject to the effect of the various requirements in the California Commercial Code regarding the maintenance of valid and perfected security interests and events occurring after the date of this opinion letter.

[*Alternative 3: Client Located in California—Other State's Law Governs Security Documents*]

2.6 Perfection of Personal Property Security Interest. Under applicable California law, the local law of the jurisdiction where the Client is located governs perfection of the Lender's security interest in personal property described in the Security Documents that is subject to Division 9 of the California Commercial Code (Article 9 Collateral) except to the extent otherwise provided in California Commercial Code §§9301(2), (3)(A)-(B), (4), and 9303-9306. Assuming that (1) the Security Documents create a valid security interest in favor of Lender in any rights of the Client in the Article 9 Collateral under the Uniform Commercial Code as adopted in the State of _ _[*name of state*]_ _ (the Personal Property Collateral), (2) this security interest has attached as of the date of this Opinion Letter, and (3) Section 9301 of the California Commercial Code is identical to the provisions of the Uniform Commercial Code of the State of _ _[*name of state*]_ _ concerning perfection and priority of security interests in personal property, because the Client is a registered organization organized under the law of the State of California, on the filing of the UCC-1 with the California Secretary of State, Lender's security interest in Article 9 Collateral, except to the extent otherwise provided in California Commercial Code §§9301(2), (3)(A)-(B), (4), and 9303-9306, that can be perfected by such a filing will be perfected. This opinion is specifically subject to the effect of the various requirements in the California Commercial Code regarding the maintenance of valid and perfected security interests and events occurring after the date of this Opinion Letter.

[*Continue*]

2.7. Usury Opinion. Assuming that no fees, charges, benefits, or other compensation will be paid, directly or indirectly, to Lender or for Lender's benefit, except as specified in the Transaction Documents, and assuming that no amounts to be paid as specified in the Transaction Documents constitute a penalty, the Transaction, as evidenced by the Transaction Documents, does not violate the State's usury laws.

2.8. No Breach or Default Opinion. Execution and delivery by the Client of, and _ _[*performance of its agreements in/payment of its obligations under*]_ _, the Transaction Documents do not (a) violate the Client's _ _[*e.g., articles of organization/certificate of incorporation or bylaws/partnership agreement or certificate*]_ _, (b) breach, or result in a default under, any existing obligation of the Client under the Other Agreements _ _[*specified in Attachment No. ___to this Opinion Letter (the Specified Other Agreements)/of which we have Actual Knowledge (as defined in the attached Glossary*]_ _, or (c) breach or otherwise violate any existing obligation of the Client under any Court Order _ _[*that is identified in Attachment No. _____ to this Opinion Letter (the Specified Court Orders), which the Client has certified to us are the only Court Orders/of which we have Actual Knowledge (as defined in the attached Glossary*]_ _. Our Opinion in this paragraph does not extend to any action or conduct of the Client that a Transaction Document may permit but does not require, except to the extent that such action or conduct takes place simultaneously with, and we had Actual Knowledge that it constituted part of, the consummation of the Transaction.

2.9. No Violation of Law Opinion. Execution and delivery by the Client of, and performance by the Client of its payment obligations in, the Transaction Documents neither are prohibited by applicable provisions of

statutory law or regulation of the State nor will subject the Client to a fine, penalty, or other similar sanction under any statutory law or regulation of the State. Our opinion in this paragraph relates only to statutory laws and regulations that _ _[*we/a lawyer*]_ _, in exercising customary professional diligence, would reasonably recognize as being directly applicable to the Client, the Transaction, or both.

[If applicable, add one or more of the following options]

[*Option: Client has an operating business, but is only represented as to real estate matters]*

2.10. This opinion is provided with the understanding that we do not represent the Client in its business operations and are not familiar with and have not reviewed any requirements of any applicable governmental statute, rule, regulation, or authority applicable to the business operations of the Client (the "Business Laws"), as distinguished from the ownership of real estate and the mortgaging of real property generally. We offer no opinion with respect to whether or not the execution and delivery of the Transaction Documents by the Client or performance by the Client of its payment obligations in the Transaction Documents would result in a violation of such Business Laws.

[*Option: Ability to pursue California collateral after enforcement on out-of-state collateral*]

2.11. Ability to Pursue California Collateral. One or more trustee's sales or foreclosure sales pursuant to the power of sale (without judicial action) in other deeds of trust or mortgages recorded against property outside of California (Outside States' Mortgages) securing the obligations of the Client under the Agreement and the Note, would not, in and of itself, under the laws of California, hinder or prevent the subsequent or concurrent foreclosure of the Deed of Trust as a result of (a) any antideficiency, fair-value, or single-action statute, rule, or other similar law of the State of California, or (b) any other statute, law, rule, interpretation, or equitable principle of the State of California. We advise you that judicial decisions in California have held that the "one form of action" rule in California Code of Civil Procedure §726 and the "fair value" provisions of California Code of Civil Procedure §580a, both discussed in _ _[*e.g., Paragraph 3.7*]_ _, do not apply to a lender who forecloses on multiple real property security in separate nonjudicial foreclosure or trustee's sales. See, *e.g., Hatch v Security-First Nat'l Bank* (1942) 19 C2d 254, 120 P2d 869; *Dreyfuss v Union Bank* (2000) 24 C4th 400, 101 CR2d 29. The opinion in this paragraph does not apply to any judicial foreclosure sales in connection with any Outside States' Mortgages, any judgment obtained in another state in connection with the Agreement or any Outside States' Mortgages prior to a foreclosure of the Deed of Trust, or any action by Lender in another state that might be construed to be an "action" for purposes of the one-action rule of California Code of Civil Procedure §726 prior to foreclosure of the Deed of Trust. Each such situation could implicate California Code of Civil Procedure §726, discussed in _ _[*e.g., Paragraph 3.7*]_ _ of this Opinion Letter. Additionally, any nonjudicial foreclosure of an Outside States' Mortgage may be subject to California Code of Civil Procedure §580d, discussed in _ _[*e.g., Paragraph 3.7*]_ _ of this Opinion Letter.

[*Option: Lender is foreign lending institution*]

2.12. Foreign Lender. Assuming that (a) the only business transacted by Lender in the State of California is that which is provided under the Transaction Documents to which it is a party and (b) Lender is a "foreign lending institution" as described in California Corporations Code §191(d), then Lender is not required under State law to qualify to do business in the State or to file any designation for service of process, or to file any reports in the State, in order to execute, deliver, perform, foreclose under, or comply with the Transaction Documents to which it is a party. We express no opinion on any qualification requirements after foreclosure. California Corporations Code §191(d) provides that a foreign lending institution includes (but is not limited to) any foreign banking corporation, any foreign corporation of which all capital stock is owned by one or more foreign banking corporations, any foreign savings and loan association, any foreign insurance company, or any foreign corporation or association authorized by its charter to invest in loans secured by real and personal property, whether organized under the laws of the United States or of any other United States state, district, or territory.

[*Option: Opinion Requested on Customary Remedies*]

2.13 Customary Remedies. The terms and provisions of the Security Documents provide for the remedies of foreclosure and the appointment of a receiver, which are the remedies customarily available to and typically utilized by lenders in California real estate secured loans transactions.

[*Continue*]

Comment: Both the status opinion in Paragraph 2.1 and the authorization opinion in Paragraph 2.2 are implicit in the remedies opinion under the Accord. See Accord Commentary §§10.4(ii)(A) and 10.4(ii)(B), respectively.

Actions by the "Client" (see Paragraph 2.2) include actions by its management, such as the members of a limited liability company or the board of directors of a corporation or the general partners of a partnership. Due diligence should cover any requisite actions and status of the members, owners, or partners.

Accord Commentary §10.4(i) states that the opinion giver must have established that all conditions necessary under

contract law for formation of a contract have occurred. See Paragraph 2.3.

Paragraph 2.4 is the "Remedies Opinion" defined in the glossary of the Accord. See also Accord Commentary §10.1. This remedies opinion follows the Accord formulation that every agreement in the transaction documents is enforceable. If the transaction documents call for arbitration, Accord §10 would call for including a provision such as Alternative 3.

If the lender requires an opinion on a guaranty or other suretyship agreement, it should follow the same form as the remedies opinion on the Transaction Documents generally (see Alternative 1 of Paragraph 2.4). The guaranty or other suretyship agreement should be included in the definition of Transaction Documents (see Paragraph 1.1) generally to make it clear that the opinion qualifications and assumptions apply to it as well. However, because a person other than the borrower will execute the guaranty/suretyship agreement, the opinions relating to the Transaction Documents in Paragraphs 2.2, 2.3, 2.7, and 2.8 should refer to the "Transaction Documents executed by the Client." The guaranty or suretyship agreement and the "guarantor/surety" should be specifically added to the definitions in the Glossary in §8.90, and, if the opinion recipient requires it, separate opinions on the subject matter of Paragraphs 2.2, 2.3, 2.7, and 2.8 should be provided for the guarantor/surety. (We have used "guaranty" and "guarantor" in this form.)

Alternatives 2 and 3 in Paragraph 2.4 should be revised to accommodate the opinion on the guaranty or suretyship agreement if the situation warrants it.

The final optional paragraph in Paragraph 2.4, which can be used with any of the three alternatives, may be superseded by the generic qualification in Paragraph 3.6, but it is still frequently used by practitioners.

The lien opinion in Paragraph 2.5 is added to the remedies opinion of the Accord by ABA-ACREL Report ¶7. Note that this opinion covers only the *form* of security documents and does not cover the Financing Statements or other issues such as actual perfection of liens.

As discussed in §8.74, under UCC Article 9 and the governing law provisions of Com C §9301, California counsel should avoid providing a perfection opinion when the borrower is organized in a state other than California. If an opinion is required, the first alternative Paragraph 2.6 and Alternative 1A within that paragraph should be acceptable to an opinion recipient and satisfy the ethical constraints involved in opining on the law of a state in which the California practitioner is not licensed.

The actual perfection opinion statement is derived from *Special Report of the Tri-Bar Opinion Committee*: *U.C.C. Security Interest Opinions—Revised Article 9*, 58 Bus Law 1449 (2003), and the Personal Property Opinion Report. This language is consistent with the revised Article 9, which is the current version of Division 9 of the California Commercial Code.

Paragraph 2.7 opines that the transaction documents do not violate usury laws. The opinion giver should be aware that the calculation of the interest rate payable under the transaction documents may raise difficult issues. See §3.38. Under ABA-ACREL Report ¶¶10 and 16, a usury opinion is implied (but is often requested by lenders even though implied). The assumption that the amounts paid do not constitute a penalty is consistent with the Generic Qualification; see Paragraph 3.8 of form.

Paragraph 2.8 is the "No Breach or Default Opinion" referred to in Accord §15. For the "Specified Other Agreements," counsel should consider using contracts dealing with money borrowed by the client; contracts filed by the client with the Securities and Exchange Commission; or other written contracts (other than the transaction documents) to which the client is a party or by which it or its property is bound. The burden of providing a no-breach opinion with respect to "Specified Other Agreements" may be cost-prohibitive if the client-borrower is not a single asset entity. See §8.44.

Paragraph 2.9 is the "No Violation of Law Opinion" referred to in Accord §16, as modified by the ABA-ACREL Report. Section 16 and the commentary to it describe the statutes or regulations that the opinion giver should consider as those that "a lawyer in the Opining Jurisdiction exercising customary professional diligence would reasonably recognize." The Accord formulation is an objective standard, taking into consideration only what lawyers would reasonably recognize as applicable, in contrast to a more subjective standard, in which the opinion giver's reasonable determination is to govern. Both formulations are used in practice, and because both are modified by the adverb "reasonably," it may be argued that both essentially mean the same thing. Often a lawyer will be asked to represent a client in its real estate transactions but does not represent the client in its business operations. If the client is the entity that is the borrower, rather than the creation of a new special purpose entity, then the lawyer should consider the optional language in Paragraph 2.10.

In transactions involving real estate collateral in a number of states, a lender may request a specific opinion on the lender's ability to pursue its California real estate collateral following an enforcement action in another state. Carefully considered, and carefully restricted, an opinion in form similar to Paragraph 2.11 may be appropriate. Also note Alternative 2 in §8.87 and the Comment.

Paragraph 2.12 is used when a foreign lending institution requires an opinion that it is not required to qualify to do

business in California as a result of the loan transaction. If the lender is not a "foreign lending institution" as defined in Corp C §191(d), an opinion giver must rely on the more general exemption from qualification provided in Corp C §191(c). The general exemption provided in §191(c)(8) ("conducting an isolated transaction completed within a period of 180 days and not in the course of a number of repeated transactions of like nature") may be the only reasonable exemption on which to base an opinion because other exemptions, though they apply to "creation," "acquisition," and/or "ownership" of loans (see Corp C §191(d)), do not refer to "making loans," although that may certainly be implied. If the entity is not a corporation, similar general exemption provisions are applicable to limited partnerships (Corp C §15611(ag)(3)(I) (Corp C §15901.02(ai)(3)(I), operative Jan. 1, 2008, for new or electing limited partnerships)) and limited liability companies (Corp C §17001(ap)(2)(I)).

Paragraph 2.13 is an acceptable compromise opinion in response to an opinion recipient's request for an opinion that the loan documents include "typical" provisions and "customary" remedies. See §8.58A.

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§8.79 D. Form: Qualifications: Assumptions

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8.79-1 Qualifications: Assumptions

3. Qualifications. Despite any provision in this Opinion Letter to the contrary, the foregoing opinions are subject to the following additional qualifications:

3.1. Assumptions. In rendering the opinions in _ _[*e.g., Paragraphs 2.1-2.9*]_ _, we have relied, without investigation, on the assumptions described in this paragraph unless in a given case the particular assumption states, directly or in practical effect, a legal conclusion expressed in the opinion:

3.1.1. _ _[*A Client who is a natural person and/Natural*]_ _ persons who are involved on the Client's behalf have sufficient legal capacity to enter into and perform the Transaction or to carry out their role in it.

3.1.2. The Client holds the requisite title and rights to any property involved in the Transaction.

3.1.3. Each party to the Transaction (other than the Client) has satisfied the legal requirements that apply to it to the extent necessary to make the Transaction Documents enforceable against it.

3.1.4. Each party to the Transaction (other than the Client) has complied with all legal requirements pertaining to its status as such status relates to its rights to enforce the Transaction Documents against the Client.

3.1.5. Each document submitted to us for review is accurate and complete; each such document that is an original is authentic; each such document that is a copy conforms to an authentic original; and all signatures on each such document are genuine.

3.1.6. Each public authority document is accurate, complete, and authentic, and all official public records (including their proper indexing and filing) are accurate and complete.

3.1.7. There has been no mutual mistake of fact or misunderstanding, fraud, duress, or undue influence.

3.1.8. The conduct of the parties to the Transaction has complied with any requirement of good faith, fair dealing, and conscionability.

3.1.9. Lender and any agent acting for Lender in connection with the Transaction have acted in good faith and without notice of any defense against the enforcement of any rights created by, or adverse claim to any property or security interest transferred or created as part of, the Transaction.

3.1.10. There are no agreements or understandings among the parties, written or oral, and there is no usage of trade or course of prior dealing among the parties that would, in either event, define, supplement, or qualify the terms of the Transaction Documents, the Other Agreements, or the Court Orders.

3.1.11. All statutes, judicial and administrative decisions, and rules and regulations of government agencies constituting the Law of the Opining Jurisdiction are generally available (*i.e.,* in terms of access and distribution following publication or other release) to lawyers practicing in the Opining Jurisdiction, and are in a format that makes legal research reasonably feasible.

3.1.12. The constitutionality or validity of a relevant statute, rule, regulation, or agency action is not in issue unless a reported decision in the Opining Jurisdiction has specifically addressed but not resolved, or has established, its unconstitutionality or invalidity.

3.1.13. Other Agreements and Court Orders (as such terms are defined in the attached Glossary) would be enforced as written.

3.1.14. The Client will not take any discretionary action (including a decision not to act) permitted under the

Transaction Documents that would result in a violation of law or constitute a breach or default under any Other Agreement or Court Order.

3.1.15. The Client will obtain all permits and governmental approvals required in the future, and take all actions similarly required, relevant to subsequent consummation of the Transaction or performance of the Transaction Documents.

3.1.16. All parties to the Transaction will act in accordance with, and will refrain from taking any action that is forbidden by, the terms and conditions of the Transaction Documents.

3.1.17. The Security Documents have been or will be duly recorded and/or filed in all places necessary (*if* and to the extent necessary) to create the lien as provided in those documents.

3.1.18. The description of the Collateral is accurate and is sufficient under Law (a) to provide notice to third parties of the liens and security interests provided by the Security Documents and (b) to create an effective contractual obligation under Law.

[*Add one of the following alternatives*]

[*Alternative 1: Syndicated loan or select single relevant exemption]*

3.1.19. (i) Lender is an admitted incorporated insurer under California Insurance Code §1100.1, or (ii) Lender is a national bank as described in Article XV, Section 1, of the California Constitution (the "California Usury Law"), or (iii) Lender is duly licensed as a "Finance Lender" under the California Finance Lenders Law (Fin C §§22000-22780), or (iv) Lender is a foreign (other nation) bank as described in California Financial Code §1716, has assets equal to at least $100,000,000, and is either licensed to maintain an office in California, is licensed or otherwise authorized by another state of the United States to maintain an agency or branch office in that state, or maintains a federal agency or federal branch in any state of the United States, or (vi) _ _[*add any other relevant exemption*]**_ _.**

[*Alternative 2: Generic assumption]*

3.1.19. Lender is a person exempt from the restrictions of the California Usury Law relating to rates of interest upon a loan or forbearance.

[*Alternative 3: Lender does not qualify for a personal exemption]*

3.1.19. The mortgage broker, _ _[*name*]**_ _, involved in connection with the Loan is a licensed real estate broker in the State of California in good standing and has "arranged" the Loan as that term is defined and used in the California Usury Law and California Civil Code §19.16.**

[*Alternative 4: Lender does not qualify for a personal exemption and Alternative 3 does not apply, but is a California Lender qualified to transact intrastate business and is appropriately licensed*]

3.1.19. To the extent required, Lender is qualified to transact intrastate business in the State of California and has complied with all legal requirements pertaining to its status as such status relates to its power to make the Loan.

[*Continue*]

3.1.20. The public record of the state of Borrower's organization which shows Borrower to have been organized as described in Section 9503(a)(1) of the California UCC is the _ _[*e.g., articles of organization/articles of incorporation/L.P. 1*]**_ _ of Borrower certified by the California Secretary of State.**

We have no Actual Knowledge that the foregoing assumptions are false. We have no Actual Knowledge of facts that, in the circumstances, would make our reliance on the foregoing assumptions unreasonable.

Comment: If the borrower is a corporation, the Accord suggests that, in rendering a "due organization" opinion, an opinion giver should be able to rely on the "presumption of regularity and continuity" for a corporation that has been in existence for many years. The Accord suggests the following language:

> In connection with our opinion in paragraph __ concerning the due organization of the Corporation, our investigation revealed that certain corporate records concerning [specify the missing records and describe their relevance] were either missing or incomplete. As a consequence, we have relied upon the presumption of regularity and continuity to the extent necessary to enable us to provide that opinion.

Certain Guidelines for the Negotiation and Preparation of Third-Party Legal Opinions Following the Accord, Part II, B.

The assumptions listed in Paragraph 3.1 are taken from Accord §4.

In rendering a no-breach or default opinion with respect to other agreements and court orders, the opinion giver is

interpreting the meaning of the provisions of the other agreements and court orders in light of the transactions contemplated by the transaction documents. In rendering any opinion interpreting an agreement or court order, the opinion giver must assume (see Paragraph 3.1.10) that these documents or court orders are unaffected by other agreements, understandings, or courses of dealing of the parties and will be enforced as written (see Paragraph 3.1.13). For a discussion of the issues giving rise to and arising out of the assumptions in Paragraphs 3.1.10 and 3.1.13, see §8.44.

The assumption in Paragraph 3.1.13 is important in the no-breach or default opinion. Other agreements binding on the client are often governed by the laws of a state other than that of the opining jurisdiction. A California lawyer may be asked to render an opinion on whether an agreement that by its terms is governed by New York law will be breached if the client enters into a loan agreement governed by California law. In the absence of the assumption that the New York documents will be enforced as written, the California opinion giver would have to hire New York counsel to decide whether the provisions of the California loan documents would result in a breach of the New York documents. If the client has multiple contracts governed by the laws of several different jurisdictions, the cost of the no-breach or default opinion would be prohibitive. The assumption in Paragraph 3.1.13 eliminates the need to examine the other agreements and court orders under their respective governing laws. In determining whether the California loan documents create problems under other agreements and court orders binding on the client, the opinion giver may assume that any court will enforce the provisions of the other agreements and court orders as written.

Paragraphs 3.1.17 and 3.1.18 were added by ABA-ACREL Report ¶4. Accord §5 describes circumstances when counsel may not rely on assumptions.

Paragraph 3.1.18(a) is necessary only if borrower's counsel is giving a perfection opinion. On perfection opinions, see §§8.68-8.70, 8.74.

Paragraph 3.1.19 implements various alternatives to deal with the California Usury Law and the various ways a lender, various members of a lending syndicate, or the loan can qualify for an exemption. Unless exempt under the provisions of the Finance Lender's Law (Fin C §22000-22780), any person making more than one consumer or commercial loan in California must have a finance lender's license. Alternative 2 may be necessary if the opinion giver has limited knowledge about the status of the lender.

Paragraph 3.1.20 is a response to the failure of Com C §9503(1) to define what the "public record of the debtor's jurisdiction of organization" is. The comments to the Uniform Commercial Code provide no guidance.

The "Actual Knowledge" statement at the end of the list of assumptions may be controversial and unwarranted with respect to many of the assumptions; a law firm may reasonably conclude that it should not be making a factual representation of this type in what should be an opinion letter based on a set of facts. For example, what would it mean in Paragraphs 3.1.5-3.1.6 to effectively represent that the stated documents are "accurate and complete"? See also §8.21.

On the impropriety of the negative assurance following Paragraph 3.1.20, see §§8.18, 8.21.

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§8.80 E. Form: Qualifications: Exclusions

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8.80-1 Qualifications: Exclusions

3.2. Exclusions. None of the Opinions in _ _[*e.g., Paragraphs 2.1-2.9*]_ _ includes any implied opinion unless such implied opinion is both (a) essential to the legal conclusion reached by those express opinions and (b) based on prevailing norms and expectations among experienced lawyers in the State, reasonable in the circumstances. Moreover, unless explicitly addressed in this Opinion Letter, the foregoing Opinions do not address any of the following legal issues, and we specifically express no Opinion on them:

3.2.1. Federal securities laws and regulations administered by the Securities and Exchange Commission (other than the Public Utility Holding Company Act of 1935), state "Blue Sky" laws and regulations, and laws and regulations relating to commodity (and other) futures and indexes and similar instruments;

3.2.2. Federal Reserve Board margin regulations;

3.2.3. Pension and employee benefit laws and regulations (*e.g.*, ERISA);

3.2.4. Federal and state antitrust and unfair competition laws and regulations;

3.2.5. Federal and state laws and regulations on filing and notice requirements (*e.g.*, Hart-Scott-Rodino and Exon-Florio), other than requirements applicable to charter-related documents such as a certificate of merger;

3.2.6. Compliance with fiduciary duty requirements;

3.2.7. Local Law;

3.2.8. With respect to Personal Property and Collateral:

(a) The characterization of the Transaction as one involving the creation of a lien on Real Property or a security interest in Personal Property except to the extent that the enforceability of remedies against the Client set forth in the Transaction Documents depends on the characterization of the Transaction expressed by the parties to it;

(b) Title to Collateral or the accuracy of its description;

(c) The sufficiency of the description of the Collateral to provide notice to third parties of the lien or security interest provided for in the Security Documents; and

(d) The creation, attachment, perfection, or priority of a lien on Real Property Collateral or a security interest in Personal Property Collateral, or enforcement of a security interest in Personal Property Collateral separately from enforcement of the lien on Real Property Collateral as contemplated by §9604 of the California Commercial Code.

3.2.9. Fraudulent transfer and fraudulent conveyance laws;

3.2.10. Federal and state environmental laws and regulations;

3.2.11. Federal and state land use and subdivision laws and regulations;

3.2.12. Federal and state tax laws and regulations;

3.2.13. Federal patent, copyright, trademark, state trademark, and other federal and state intellectual property laws and regulations;

3.2.14. Federal and state racketeering laws and regulations (*e.g.*, RICO);

3.2.15. Federal and state health and safety laws and regulations (*e.g.*, OSHA);

3.2.16. Federal and state labor laws and regulations;

3.2.17. Federal and state laws, regulations, and policies on (a) national and local emergencies, (b) possible judicial deference to acts of sovereign states, and (c) criminal and civil forfeiture laws; and

3.2.18. Other federal and state statutes of general application to the extent they provide for criminal prosecution (*e.g.,* mail fraud and wire fraud statutes).

[*Option in lieu of paragraphs 3.2.1-3.2.5, 3.2.10, and 3.2.18*]

3.2.1. The applicability of, or effect of, or compliance with, any laws that are not customarily recognized as being applicable to transactions similar to those being contemplated by the Transaction Documents, which noncustomary laws include the following: (a) any federal or state antitrust laws; (b) securities laws (including the Securities Act of 1933, as amended); (c) taxation laws; (d) receivership or conservatorship laws; (e) real estate or mortgage brokerage licensing laws; (f) banking laws; (g) environmental laws or statutory requirements relating to the disposition of hazardous wastes or environmental protection; (h) worker health, safety, building code, zoning or permitting, or land use matters; (i) pension and employee benefit laws; (j) patent laws, (k) trademark or copyright statutes; and the rules and regulations pertaining to such noncustomary laws.

Comment: The first sentence of Paragraph 3.2 is derived from Accord §18. The list of excluded legal issues (see Paragraphs 3.2.1-3.2.18) is from Accord §19. Paragraph 3.2.9 is taken from the ABA-ACREL Report ¶17, and ABA-ACREL Report ¶18 notes that this qualification is not inconsistent with the opinion in Paragraph 2.5. Paragraph 2.5 speaks to the form of documents, while Paragraph 3.2.9 covers the actual status of the lien or security interest. The ABA-ACREL Report ¶18 notes that the status of the lien on real property collateral is customarily dealt with solely by title insurance, and an opinion on the status of a security interest on personal property collateral should be given separately (if at all). See §§8.73-8.75.

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§8.81 F. Form: Qualifications: Bankruptcy and Insolvency Exception

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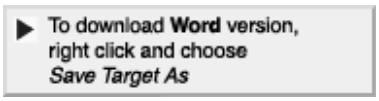

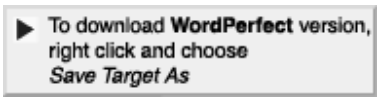

8.81-1 Qualifications: Bankruptcy and insolvency exception

3.3. Bankruptcy and Insolvency Exception. The Opinion in _ _[*e.g., Paragraph 2.4*]_ _ of this Opinion Letter is subject to the following qualifications: The effect of bankruptcy, insolvency, reorganization, receivership, moratorium, and similar laws affecting the rights and remedies of creditors generally. This exception includes the following:

3.3.1. The federal Bankruptcy Code and thus comprehends, among others, matters of turnover, automatic stay, avoiding powers, fraudulent transfer, preference, discharge, conversion of a nonrecourse obligation into a recourse claim, limitations on ipso facto and antiassignment clauses, and the coverage of prepetition security agreements applicable to property acquired after a petition is filed;

3.3.2. All other federal and state bankruptcy, insolvency, reorganization, receivership, moratorium, arrangement, and assignment for the benefit of creditors laws that affect the rights and remedies of creditors generally (not just creditors of specific types of debtors);

3.3.3. All other federal bankruptcy, insolvency, reorganization, receivership, moratorium, arrangement, and assignment for the benefit of creditors laws that refer to or generally affect only creditors of specific types of debtors and state laws of like character generally affecting only creditors of financial institutions and insurance companies;

3.3.4. State fraudulent transfer and conveyance laws; and

3.3.5. Judicially developed doctrines relevant to any of the foregoing laws, such as substantive consolidation of entities.

Comment: Paragraph 3.3 is the "Bankruptcy and Insolvency Exception" in Accord §12.

The qualifications in Paragraphs 3.3-3.4 (see §8.82), and 3.5 (see §8.83) correspond to the general qualifications described in Accord §§11-14. Consistent with the presumption established by the Accord, this opinion letter is written as if the general qualifications apply only to the remedies opinion (see Paragraph 2.4). The Accord permits any or all of the general qualifications to be made applicable, by agreement between the opinion giver and the opinion recipient, to any opinion in addition to the remedies opinion. Accord §21 (Modification and Private Ordering). Similarly, the ABA-ACREL Report permits the generic qualification in Paragraph 3.8 (see §8.86) to be made applicable to opinions in addition to the remedies opinion.

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§8.82 G. Form: Qualifications: Equitable Principles Limitation

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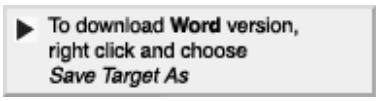

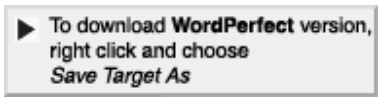

8.82-1 Qualifications: Equitable principles limitation

3.4. Equitable Principles Limitation. The opinion in _ _[*e.g., Paragraph 2.4*]_ _ of this Opinion Letter is subject to the following qualifications: The effect of general principles of equity, whether applied by a court of law or equity. This limitation includes principles:

3.4.1. Governing the availability of specific performance, injunctive relief, or other equitable remedies that generally place the award of such remedies, subject to certain guidelines, in the discretion of the court to which application for such relief is made;

3.4.2. Affording equitable defenses (*e.g.*, waiver, laches, and estoppel) against a party seeking enforcement;

3.4.3. Requiring good faith and fair dealing in the performance and enforcement of a contract by the party seeking its enforcement;

3.4.4. Requiring reasonableness in the performance and enforcement of an agreement by the party seeking enforcement of the contract;

3.4.5. Requiring consideration of the materiality of (a) the Client's breach and (b) the consequences of the breach to the party seeking enforcement;

3.4.6. Requiring consideration of the impracticability or impossibility of performance at the time of attempted enforcement; and

3.4.7. Affording defenses based on the unconscionability of the enforcing party's conduct after the parties have entered into the contract.

Comment: This is the "Equitable Principles Limitation" in Accord §13.

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§8.83 H. Form: Other Common Qualifications

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8.83-1 Other common qualifications

3.5. Other Common Qualifications. The opinion in _ _[*e.g., Paragraph 2.4*]_ _ of this Opinion Letter is subject to the following qualifications: To the extent the Law of the State applies any of the following rules to one or more of the provisions of the Transaction Documents covered by an opinion to which this paragraph applies, that opinion is subject to the effect of generally applicable rules of Law that:

3.5.1. Limit or affect the enforcement of provisions of a contract that purport to require waiver of the obligations of good faith, fair dealing, diligence, and reasonableness;

3.5.2. Provide that forum selection clauses in contracts are not necessarily binding on the court(s) in the forum selected;

3.5.3. Limit the availability of a remedy in circumstances in which another remedy has been elected;

3.5.4. Limit a creditor's right to use force or cause a breach of the peace in enforcing rights;

3.5.5. Relate to the sale or disposition of collateral or the requirements of a commercially reasonable sale, including, without limitation, statutory cure provisions and reinstatement rights and limitations on deficiency judgments;

3.5.6. Limit the enforceability of provisions releasing, exculpating, or exempting a party from, or requiring indemnification of a party for, liability for its own action or inaction, to the extent that the action or inaction involves gross negligence, recklessness, willful misconduct, or unlawful conduct;

3.5.7. May, when less than all of a contract may be unenforceable, limit the enforceability of the balance of the contract to circumstances in which the unenforceable portion is not an essential part of the agreed exchange;

3.5.8. Govern and afford judicial discretion on the determination of damages and entitlement to attorney fees and other costs;

3.5.9. May, in the absence of a waiver or consent, discharge a guarantor to the extent that (a) action by a creditor impairs the value of collateral securing guaranteed debt to the detriment of the guarantor, or (b) guaranteed debt is materially modified;

3.5.10. May permit a party who has materially failed to render or offer performance required by the contract to cure that failure unless (a) permitting a cure would unreasonably hinder the aggrieved party from making substitute arrangements for performance, or (b) it was important in the circumstances to the aggrieved party that performance occur by the date stated in the contract;

3.5.11. Limit or affect the enforceability of a waiver of a right of redemption;

3.5.12. Impose limitations on attorney fees or trustees' fees;

3.5.13. Limit or affect the enforceability of any provision that purports to prevent any party from becoming a mortgagee-in-possession, despite any enforcement actions taken under the Security Documents; and

3.5.14. Limit or affect the enforceability of provisions for late charges, prepayment charges, or yield maintenance charges, or acceleration of future amounts due (other than principal) without appropriate discount to present value, liquidated damages, and penalties.

[*If applicable, add one or more of the following options*]

[*Option 1: Use of insurance or condemnation proceeds to reduce debt*]

3.5.15. Limit or affect the enforceability of provisions allowing the application of insurance or condemnation proceeds to reduce indebtedness;

[*Option 2: Acceleration on transfer*]

3.5.16. Limit or affect the enforceability of provisions that provide for the acceleration of indebtedness on any transfer or change in the control, ownership, or management of any party,

[*Option 3: Assignment of rents*]

3.5.17. Limit or affect the enforceability of provisions purporting to assign the rents, issues, and profits of the Real Property (which will be subject to and enforceable in accordance with California Civil Code §2938).

Comment: Paragraph 3.5 contains the "Other Common Qualifications" from Accord §14, as modified by ABA-ACREL Report ¶¶12-13. Depending on the generic qualifications in Paragraph 3.8 in §8.86, some or all of these other common qualifications may be superfluous, but "customary practice" strongly suggests that they remain part of the form. The opinion giver may wish to consider omitting 3.5.9 if 3.7.9 respecting guarantors is included in the opinion.

See ABA-ACREL Report ¶13 regarding Paragraph 3.5.5.

The following opinions duplicate one another: 3.6.5 duplicates 3.5.13, 3.6.8 duplicates 3.5.6, and 3.6.12 duplicates 3.5.14. The opinion giver should choose between the formulations of each opinion.

Paragraphs 3.5.15 through 3.5.17 contain additional rules that would have been added to Accord §14 by the "Exposure Draft" of the ABA-ACREL Report but were deleted in the "prepublication" and "publication" drafts. Some or all of these three optional qualifications may be appropriate in certain circumstances. The assignment-of-rents qualification in Paragraph 3.5.17 might be expanded, in appropriate circumstances, to disclaim any "true sale" or "true lease" opinion, as well as disclaiming any opinion that a purported absolute assignment of rents would be enforced as such. Opinion paragraphs 3.6.19 (form 8.84-1) and 3.7.5.1 (form 8.85-1), if included, may be sufficient.

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§8.84 I. Form: California Qualifications

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8.84-1 California qualifications

3.6. California Qualifications. We express no opinion on the validity or enforceability of any provisions of the Transaction Document that:

3.6.1. Require Borrower to provide hazard insurance coverage against risks in an amount exceeding the replacement value of any improvements to real property;

3.6.2. Impose requirements on impound accounts in conflict with applicable law;

3.6.3. Provide for the application of insurance or condemnation proceeds to reduce indebtedness;

3.6.4. Purport to make any assignment of rents, issues, and profits from the Collateral enforceable without Lender's taking steps to enforce in accordance with California Civil Code §2938 or which purport to allow Lender to collect rents, issues, and profits and not apply those collections to the indebtedness secured by the Security Documents;

3.6.5. Purport to prevent any party from becoming a mortgagee-in-possession despite any enforcement actions taken under or in connection with the Transaction Documents;

3.6.6. Contain a waiver of any party's statutory right to reinstate a secured obligation by paying the delinquent amounts of the fully accelerated debt at any time before the time provided by statute or that contain a waiver of any right of redemption;

3.6.7. Are in conflict with any laws governing foreclosure and disposition procedures on any Collateral or in conflict with any limitations on attorney fees or trustees' fees;

3.6.8. Indemnify any party against its own negligence or willful misconduct;

3.6.9. Are in conflict with the real property antideficiency, fair value, and one-form-of-action provisions of California law;

3.6.10. Provide for the acceleration of any indebtedness on any transfer or further encumbrance of any of the Collateral for any loan, or on a change of ownership of any entity that directly or indirectly owns any interest in any such Collateral, except to the extent that (a) such provisions are enforceable under the federal preemption of the Garn-St. Germain Depository Institutions Act of 1982, as set forth in 12 United States Code §1701j-3 and regulations adopted under that Act and statute or (b) enforcement is reasonably necessary to protect against an impairment of Lender's security or an increase in the risk of default;

3.6.11. Select any jurisdiction's laws to govern any of the Transaction Documents;

3.6.12. Provide for penalties, liquidated damages, acceleration of future amounts due (other than principal) without appropriate discount to present value, late charges, prepayment charges, and increased interest rates upon default;

3.6.13. Provide that time is of the essence;

3.6.14. Provide for the confession of judgment;

3.6.15. Contain a waiver of (a) broadly or vaguely stated rights, (b) the benefits of statutory, regulatory, or constitutional rights, unless and to the extent the statute, regulation, or constitution explicitly allows waiver, (c) unknown future defenses, and (d) rights to damages;

3.6.16. Attempt to change or waive rules of evidence or fix the method or quantum of proof to be applied in

litigation or similar proceedings;

3.6.17. Select the forum for the resolution of any disputes or consents to the jurisdiction of any jurisdiction (both for personal jurisdiction and subject matter jurisdiction); or

3.6.18. Appoint one party as an attorney-in-fact for an adverse party.

3.6.19. Purport to absolutely assign contracts, permits, licenses, or similar Collateral; those provisions will most likely be enforceable as a security agreement subject to all provisions of the California Commercial Code, and all limitations and qualifications regarding the enforceability of security agreements subject to the California Commercial Code as set forth in this Legal Opinion. _ _[*No opinion is expressed on the provisions of the _ _*[*describe document in which the assignment appears*]*_ _ that may permit the Lender to exercise rights and remedies under the assigned items upon an "Event of Default" as defined therein, and before foreclosure under the _ _*[*describe document in which the assignment appears*]*_ _ and the Deed of Trust*]**_ _.**

3.6.20. Purport to incorporate by reference in the Security Documents any Transaction Documents (other than the Security Documents) that are governed by the law of a State other than California, or any provisions therein, or the enforceability of any such provisions, that are assumed, for the purposes of this opinion, to be enforceable against the Client.

Comment: For discussion of California qualifications and applicable statutory and case law, see §§8.23-8.25. The following opinions duplicate one another: 3.6.5 duplicates 3.5.13, 3.6.8 duplicates 3.5.6, and 3.6.12 duplicates 3.5.14. The opinion giver should choose between the formulations of each opinion.

The Garn-St. Germain Depository Institutions Act of 1982 (discussed in §8.23) and its related regulations do not expressly address the enforceability of provisions that permit acceleration on indirect change in the ownership of the borrower. Accordingly, the enforceability of such provisions may be subject to the limitations in clause (b) of Paragraph 3.6.10.

The qualifications in Paragraphs 3.6.11-3.6.18 are taken, with the permission of the Business Law Section of the California State Bar, from the 1992 California Business Law Report, with some minor changes in wording. Please see that Report for a discussion of these exceptions.

The provisions of the Accord and the ABA-ACREL Report with respect to governing law and choice of law and the relationship on these points between the Accord and the ABA-ACREL Report are quite complex. The inclusion in the opinion of Paragraph 3.6.11 results in the opinion's being given solely under the laws of California, without regard to California's choice-of-law rules.

The 1992 California Business Law Report at footnote 18 discusses choice-of-law provisions, noting the expiration of CC §1646.5. Since the publication of the 1992 California Business Law Report, §1646.5 has been reenacted. Depending on the factual circumstances, an opinion giver can often give an opinion that a provision selecting California law will be enforced or can provide a reasoned opinion on that issue. It is preferable in this complex area for the opinion giver to begin with a standard exception for choice of law and then consider whether to modify or delete that exception in a particular transaction.

The qualification in Paragraph 3.6.12 is somewhat duplicative of the qualification incorporated by reference from the ABA-ACREL Report. The qualification in that report, however, does not cover default rates of interest, and the 1987 California Real Property Report recommends including an exception to an enforceability opinion with respect to default rates. In certain transactions, the enforceability of prepayment charges, late charges, default interest rates, and liquidated damages provisions may be of material importance to the parties. In such instances, an opinion may be requested and given in accordance with Accord §21 (Modification and Private Ordering).

The 1992 California Business Law Report at footnote 26 has a discussion of forum selection clauses (see Paragraph 3.6.17). After the publication of the 1992 Report, CCP §410.40 was reenacted. Consequently, in certain transactions it may be possible to modify or delete this exception where a California forum, rather than another forum, is selected.

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§8.85 J. Form: California Law Qualification

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8.85-1 California law qualification

3.7. California Law. With respect to opinions set forth above, you should be aware of the following provisions of California law:

3.7.1. California Code of Civil Procedure §726 provides that any action to recover on a debt or other right secured by a mortgage or a deed of trust on real property must comply with the requirements of that section, which relate to and specify the procedures for the sale of encumbered property, the application of proceeds, the rendition in certain instances of a deficiency judgment, and other related matters. We advise you that, in such an action or proceeding, the debtor may require the creditor to exhaust all its security before a personal judgment may be obtained against the debtor for a deficiency. We also advise you that failure to comply with §726 (including but not limited to (i) an attempt to exercise a setoff right with respect to any funds of Borrower that may be deposited with you from time to time and on which you do not hold a perfected security interest, (ii) any attempt to separately enforce any of the obligations secured by the Deed of Trust, or (iii) a voluntary release of real property collateral other than in accordance with the release provisions of the Transaction Documents, without the consent or acquiescence of borrower) may result in the loss of your lien on the Real Property Collateral. See, *e.g., Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201; *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897. For example, in *Security Pac. Nat'l Bank v Wozab*, *supra,* the lender was held to have lost its lien on real property security by exercising a setoff right with respect to funds of the borrower deposited with the lender, to which the lender did not have a security interest.

3.7.2. California Code of Civil Procedure §580b provides that no deficiency judgment shall be rendered on a purchase-money obligation in the vendor's favor arising from the sale of real property when such purchase-money obligation is secured by a lien on the real property purchased from the vendor, or in a lender's favor when the loan proceeds are used to purchase a one-to-four unit family dwelling occupied entirely or in part by the borrower and when the loan is secured by a lien on that dwelling.

3.7.3. California Code of Civil Procedure §580d provides that no deficiency judgment shall be rendered on a note secured by a deed of trust or mortgage on real property after sale of the real property under the power of sale in such deed of trust or mortgage.

3.7.4. To the extent that California Code of Civil Procedure §580d may not apply, California Code of Civil Procedure §580a provides that, when a money judgment is sought for the balance due on an obligation for the payment of which a deed of trust or mortgage with power of sale on real property or any interest in it was given as security, following the exercise of the power of sale in such deed of trust or mortgage, the judgment may not exceed the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value of the real property or interest in it sold at the time of sale, with interest, from the date of the sale; provided, however, that in no event shall the amount of the judgment, exclusive of interest after the date of sale, exceed the difference between the entire amount of the indebtedness secured by the deed of trust or mortgage and the amount for which the property was sold.

3.7.5. California Civil Code §2924c provides that, whenever the maturity of an obligation secured by a deed of trust or mortgage on real property is accelerated because of a default in the payment of interest or in the payment of any installment of principal or other sums secured thereby, or because of failure of the trustor or mortgagor to pay taxes, assessments, or insurance premiums, the trustor or mortgagor and certain other specified persons have the right, which may be exercised at any time within the reinstatement period described in §2924c, to cure such default by paying the entire amount then due (including certain reasonable costs and expenses incurred in enforcing such obligations, but excluding any principal amount that would not then be due had no default occurred) and thus cure the default and reinstate the deed of trust or mortgage and the obligations secured thereby to the same effect as if no acceleration had occurred. If the power of sale in the deed of trust or mortgage is not to be exercised, this reinstatement right may be exercised at any time before entry of a decree of foreclosure.

3.7.5.1. The enforcement of the assignment of or security interest in "leases" and "rents" as defined in the Security Documents, to the extent such Leases and Rents do not constitute "leases," "rents," "issues," and

"profits" (as those terms are used in California Civil Code §2938), shall be governed by and subject to the California Commercial Code.

3.7.6. Enforcement of any of the Transaction Documents that concern the rights of Lender and obligations of Borrower _ _[*add any other parties executing such documents*]**_ _ in connection with environmentally impaired property will be subject to and limited by California Code of Civil Procedure §726.5, which in certain circumstances authorizes a real-estate-secured commercial lender to waive its lien against a parcel of "environmentally impaired" security (as defined in §726.5) and sue Borrower without foreclosing on the real property security for the loan.**

3.7.7. Enforcement of any of the Transaction Documents that concern the rights of Lender and obligations of Borrower _ _[*add any other parties executing such documents*]**_ _ in connection with environmentally impaired property will be subject to and limited by California Code of Civil Procedure §736, which permits a lender, in certain circumstances, to sue for breach of contract relating to any "environmental provisions" (as defined in §736) concerning real property security without foreclosing on the real property security or in an action brought following foreclosure, whether judicial or nonjudicial.**

[*If applicable, add one of the following two options*]

[*Option 1: Guaranty by general partner*]

3.7.8. In certain circumstances, a guaranty or other suretyship obligation executed by a general partner of a partnership borrower may not be enforceable as an obligation separate and distinct from the primary obligations described in that obligation. See, *e.g.*, *Riddle v Lushing* (1962) 203 CA2d 831, 21 CR 902.

[*If nonrecourse loan, add*]

This is true even if the loan is nonrecourse to Borrower. *Westinghouse Credit Corp. v Barton* (CD Cal 1992) 789 F Supp 1043.

[*Continue with option*]

If the Guarantor is deemed to be liable as a principal, it is likely that the Guarantor is also entitled to the rights and defenses otherwise available to a principal, including the protection of California's one-action and antideficiency laws.

[*Option 2: Guaranty from shareholder of corporate borrower, member of limited liability company, or limited partner that owns substantially all economic interests of borrower*]

3.7.8. In certain circumstances, a guaranty or other suretyship obligation executed by a _ _[*e.g., shareholder/member/limited partner*]**_ _ in Borrower who is the owner of substantially all the economic interest, either directly or indirectly, in Borrower may not be enforced as an obligation separate from the primary obligation if it is determined that Borrower is merely an alter ego or nominee of the surety and that the "true" borrower is the surety. In general, the circumstances under which a _ _**[*[limited liability company/limited partnership]*]**_ _ is deemed the alter ego of its _ _**[*members/limited partners*]**_ _ are the same as those under which a corporation is deemed to be the alter ego of its shareholders. If the surety is deemed to be liable as a principal, it is likely that the surety will also be entitled to the rights and defenses otherwise available to a principal, including the protection of California's one-action and antideficiency laws. See, *e.g., Valinda Builders, Inc. v Bissner* (1964) 230 CA2d 106, 40 CR 735. For purposes of this Opinion, we have assumed, without independent investigation, that Borrower is adequately capitalized for the purpose of conducting its business, that neither Borrower nor any intermediate entity was formed solely for the purpose of acting as agent for or as an instrumentality of Guarantor, and that Borrower maintains and will continue to maintain an identity independent of and separate from Guarantor or any intermediate entity.**

[*If applicable, add the following option*]

[*Option: Guaranty or other suretyship obligation executed by person other than borrower*]

3.7.9. To the extent that any of the Transaction Documents are construed as suretyship obligations, sureties have various rights and defenses to suretyship obligations under the laws of the State. See, *e.g.*, California Civil Code §§2819-2854. California statutes and case law provide that a surety may be exonerated if the creditor (a) materially alters the original obligation of the principal without the surety's consent; (b) elects remedies for default that impair the surety's subrogation rights against the principal; or (c) otherwise takes any action, without notifying the surety, that materially prejudices the guarantor. See, *e.g.*, California Civil Code §2810; *Sumitomo Bank v Iwasaki* (1968) 70 C2d 81, 73 CR 564; *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64. There is authority to the effect, however, that a surety may validly waive such rights if the waivers are expressly set forth in the suretyship document. California Civil Code §2856; *Krueger v Bank of America* (1983) 145 CA3d 204, 193 CR 322. California Civil Code §2856(b) states that any language expressly setting forth a waiver of suretyship rights or defenses shall be effective. Subsections (c) and (d) of §2856 provide specific language that is deemed to create an effective waiver of the surety's defenses to a recovery by the creditor

because the principal's obligation is secured by real property or because the creditor may exercise an election of remedies.

[*Compare suretyship waivers in guaranty or suretyship agreement to §2856 requirements and modify or eliminate next sentence accordingly*]

Subject to the other qualifications in this opinion, the waivers of the Guarantor's suretyship rights and defenses in the Guaranty should be enforceable.

[*Continue with option*]

However, to the extent that any of the suretyship obligations are themselves secured by a lien on real property, any waiver of rights under California Code of Civil Procedure §§580a, 580d, 726 as to such suretyship obligations, as opposed to the obligations of a party for whom the surety may be a surety and that may be secured by liens on real property, will not be enforceable, and such obligations will be subject to the one action and antideficiency qualification set forth above. Due to the limited case law since the enactment of California Civil Code §2856, however, we express no opinion on the effect of (a) any modification to or amendment of the obligations of Borrower that materially increases such obligations; (b) any election of remedies by Lender following an event of default under the Transaction Documents (other than the Guaranty); or (c) any other action by Lender that materially prejudices the Guarantor, if, in any such instance, such modification, election, or action occurs without notice to the Guarantor and without granting to the Guarantor an opportunity to cure any default by Borrower.

[*If applicable, add the following option*]

[*Option: Completion guaranty*]

3.7.10. Remedies under the Completion Guaranty may be limited to an action for damages. Damages under the Completion Guaranty may be limited to the amount by which your security is impaired by a breach in such Guaranty. *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co*. (1977) 66 CA3d 101, 135 CR 802.

[*If applicable, add the following option*]

[*Option: Up-stream or side-stream guaranty*]

3.7.11. A suretyship obligation is not enforceable under the California fraudulent transfer law if the surety (a) was either insolvent when the guaranty was made or was rendered insolvent by making the guaranty and (b) did not receive "reasonably equivalent value" for the guaranty under the California Uniform Fraudulent Transfer Act (UFTA) (California Civil Code §§3439-3439.12). When an entity such as the Guarantor _ _[*e.g., guarantees/provides additional security for*]_ _ the obligations of a _ _[*parent/sibling*]_ _ entity such as Borrower, the Guarantor may not receive reasonably equivalent value. If so, the enforceability of the Guaranty may be subject to question under the UFTA. In general, intangible benefits to the Guarantor resulting from benefits to its affiliates will not suffice. See *Moody v Security Pac. Bus. Credit, Inc.* (3d Cir 1992) 971 F2d 1056. Nevertheless, indirect benefits may suffice if the various entities involved have a sufficient degree of integration in operations, finances, and management control so that benefits to the borrowing entity might constitute reasonably equivalent value for a guaranty given by an affiliated, but not directly benefited, entity. *See In re Fairchild Aircraft Corp.* (5th Cir 1993) 6 F3d 1119. We express no opinion on whether the Guarantor has received reasonably equivalent value for the Guaranty or whether the Guarantor is currently solvent or is rendered insolvent by the Guaranty.

[If usury assumptions do not apply, add if appropriate]

3.7.12. With respect to the opinion expressed above as it relates to the California Usury Law, we assume based on the unpublished case of *Raceway Props., LLC v LSOF Carlsbad Land* (9th Cir 2005) 157 Fed Appx 959, that California Corporations Code §25118 provides for two separate and distinct exemptions in Subsections (a) and (b) thereof. With respect to the exemption provided in Subsection (b) there are two potential bases upon which the Loan may be exempt from the California Usury Law. California Corporations Code §25118 exempts "evidences of indebtedness [which] aggregate at the time of issuance at least three hundred thousand dollars ($300,000) in original face amount," provided that the loan is not guarantied "by an individual, a revocable trust having one or more individuals as trustors or a partnership in which, at the time of issuance, one or more individuals are general partners" (Subsection (e)(1)) and either Subsection 25118(f)(1) or Subsection 25118(f)(2) applies. The Loan, which will be evidenced by the Note, is for more than three hundred thousand dollars ($300,000). We assume that the Loan is not guarantied by a party as described in Subsection (e)(1). Subsection 25118(f)(1) provides that the exemption is only available if "[t]he lender and either the issuer of the indebtedness or the guarantor, as the case may be, or any of their respective officers, directors, or controlling persons, or, if any party is a limited liability company, the managers as appointed or elected by the members, have a preexisting personal or business relationship." We have therefore assumed, without investigation, that each of Borrower and Lender and persons who will become a Lender pursuant to a contract in existence at the time of the closing of the Loan has "a pre-existing personal or business relationship" as required by Subsection 25118(f)(1), and therefore, on this basis the Loan would be exempt from the usury

provisions of the California Usury Law pursuant to Corporations Code §25118.

Alternatively, Corporations Code Subsection 25118(f)(2) provides that an exemption is available if "[t]he lender and the issuer, or the lender and the guarantor, by reason of their own business and financial experience or that of their professional advisers, could reasonably be assumed to have the capacity to protect their own interests in connection with the transaction." We have assumed, without investigation, that Lender and persons who will become a Lender pursuant to a contract in existence at the time of the closing of the Loan and Borrower "by reason of their business and financial experience or that of their professional advisors, could reasonably be assumed to have the capacity to protect their own interests in connection with the transaction" as required by Subsection 25118(f)(2), and therefore the Loan would be exempt from the provisions of the California Usury Law under Corporations Code §25118.

Comment: The optional qualifications in Paragraph 3.7.8 are appropriate if a guaranty or other suretyship type agreement (*e.g.*, a deed of trust or pledge of collateral by a person who is not the borrower) is one of the Transaction Documents, if the structure of the transaction and the documentation fit the discussion in the qualifications, and if an opinion on the guaranty or other suretyship type agreement is required. The alternative paragraphs are adapted from the 1987 California Real Property Report.

One must be careful to recognize when a Transaction Document is a suretyship agreement. A document titled "Guaranty" is the simple case. A pledge of other collateral by a principal in the borrowing entity is not as easy. It is also possible that the execution of an environmental indemnity agreement by someone other than the borrower will constitute a suretyship obligation from that person to the lender. Persons who may be sureties may be entitled to the rights and defenses under general suretyship law and the suretyship provisions in CC §§2787-2856.

For many years lawyers disagreed over the extent to which waivers of suretyship rights and defenses would be enforceable, culminating with *Cathay Bank v Lee* (1993) 14 CA4th 1533, 18 CR2d 420, which held that a waiver of a suretyship right or defense must be explicit, so that the surety would know what it is waiving. Factually, the waiver in *Cathay Bank* was similar to waiver language in many standard institutional lender guaranties, both then and today. In 1996, CC §2856 was added to the Civil Code to permit a surety to waive all suretyship rights and defenses, including those that could otherwise provide the surety with the benefits of the California one-action and antideficiency rules. Such a waiver of those suretyship rights and defenses that arise either from an election of remedies by the lender or because the primary obligation is secured by real property may result from any "other language to express an intent to waive all rights and defenses" as conceived by CC §2856. Specific safe harbor language is provided in the statute, which if used will constitute the appropriate waiver.

The opinion giver, therefore, must carefully review the waivers to ascertain whether the assurance in the qualification (that the waivers should be enforceable) is proper. If not, it should be deleted or modified to fit the circumstances. It is important that the assurance be subject to other qualifications of the opinion, because they may affect the enforceability of the waivers, despite compliance with CC §2856. If there are no waivers, or if the waivers are limited, the first sentence of the qualification (see Paragraph 3.7.9) should be sufficient to call the opinion recipient's attention to the possible range of suretyship rights and defenses available to the surety. The remainder of the language of the qualification is based on the 1987 California Real Property Report, as modified to incorporate CC §2856.

NOTE: Section 2856 applies only to suretyship agreements executed on or after January 1, 1997. Thus, if an opinion is requested on an existing suretyship agreement that was executed before this date, the opinion giver may need to qualify the opinion further.

Completion guaranties (see Paragraph 3.7.10) are generally drafted broadly to provide a construction lender with a plethora of remedies if the borrower fails to complete, or even continue with, construction of improvements. The only case law on the enforceability of such remedies is several paragraphs in *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135 CR 802, which suggest that the available remedy is a claim for damages. See Geiger & Allen, *Fool with a Pen*, 28 Los Angeles Law 35 (Jan. 2006). Although the general remedies qualification would cover the limitations to the enforceability of a completion guaranty, many practitioners nevertheless provide the opinion recipient with the citation to this seminal case setting forth the limitation as it applies to completion guaranties.

Although the bankruptcy and insolvency exception is sufficient to cover the qualification in Paragraph 3.7.11, a lender may nevertheless specifically request an opinion on the applicability of the California fraudulent transfer law to the enforceability of a guarantor executed by an affiliate (corporate, partnership, or limited liability company) of the borrower. The opinion is generally fact-sensitive and should rarely be provided by the opinion giver. A general discussion of the issue may be appropriate in certain situations, with no conclusion reached on the application of the law to the facts of the case. Any comfort on this issue may best be obtained from an accounting firm.

The usury qualification in Paragraph 3.7.12 is a last resort to be used only when no other exemption is available

(see Alternatives 1-4 of paragraph 3.1.19 in form 8.79-1). Since applicability of this exemption is largely factual in nature, the opinion giver is left with little choice but to assume the existence of the factual basis for the applicability of the exemption as, other than the case cited in the qualification, there is little judicial guidance regarding what may constitute a "preexisting personal or business relationship" between the borrower and lender or the persons in charge of the borrower and lender, or the ability of the borrower and lender by themselves or through their professional advisors to protect themselves. This usury exemption is based on securities law concepts of sophistication that are highly factual in nature.

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§8.86 K. Form: Generic Qualification

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8.86-1 Generic qualification

3.8. Generic Qualification. The Opinion in _ _[*e.g., Paragraph 2.4*]**_ _ of this Opinion Letter is subject to the qualification that certain _ _**[*remedies, waivers, and other*]**_ _ provisions of the Transaction Documents may not be enforceable; nevertheless, subject to the other qualifications set forth in this Opinion Letter, _ _**[*and any express limitations set forth in the Transaction Documents*]**_ _ such unenforceability**

[*Add one of the following two alternatives*]

[*Alternative 1: ABA-ACREL approach*]

will not render the Transaction Documents invalid as a whole or preclude _ _[(a) *the judicial enforcement of the Client's obligation to repay the principal, with interest (to the extent not deemed a penalty), as provided in the Note;*]**_ _ _ _**[*(a/b)*]**_ _ the acceleration of the obligation of the Client to repay such principal, together with such interest, on a _ _**[*material*]**_ _ default by the Client in the payment of such principal or interest _ _**[*or upon a material default in any other material provision of the Transaction Documents*]**_ _; or _ _**[*(b/c)*]**_ _ the foreclosure in accordance with applicable Law of the lien on and security interest in the Collateral created by the Security Documents on maturity or on acceleration under clause _ _**[*(a/b)*]**_ _ above.**

[*Alternative 2: Traditional or practical realization approach*]

does not make the Transaction Documents legally inadequate for the _ _[*practical*]**_ _ realization of the principal benefits or security _ _**[*intended to be*]**_ _ provided thereby _ _**[, *subject to the economic consequences of any delay that may result from applicable law, rules, or judicial decisions*]**_ _.**

Comment: Alternative 1 of Paragraph 3.8 is the "Generic Qualification," which, together with the assurances that go with it and several alternative formulations of such provisions, is discussed at length in ABA-ACREL Report ¶¶11-11A. The same volume contains another thoughtful analysis: Holtzschue, *Opinions on Real Estate Transactions in a Post-Accord World: The Opinion Giver's Perspective*, 29 Real Prop Prob & Tr J 655, 697-717 (1994). The ABA-ACREL Report did not specifically endorse any particular form of generic qualification. This paragraph is derived, with some modification, from the American College of Real Estate Lawyers Statement of Policy on Mortgage Loan Enforceability Opinions, The Attorney's Opinion Letter in Real Estate Transactions 1 (American College of Real Estate Lawyers, 1992) and further modified by the authors in light of the limitations of California law as discussed in this Comment.

Paragraph 3.8(a) would rarely, if ever, be used in a California real property secured transaction opinion as a result of the one-form-of-action rule and other limitations on deficiency judgments, which preclude, except in extraordinary circumstances, judicial enforcement of the obligation other than following a judicial foreclosure proceeding. Consider, if appropriate, adding the exception for limitations in the transaction documents, such as nonrecourse provisions.

On the use of the word "material" in Paragraph 3.8(b) of Alternative 1, see Accord §13(e) and Paragraph 3.4.5 in §8.82.

The language of Paragraph 3.8(a)/(b) of Alternative 1 on the acceleration of the loan for a material breach of a material provision is described in ABA-ACREL Report ¶11A as an alternative. Some argue that this phrase can be a trap for the unwary and that such a material provision should be specifically identified by including in the opinion letter a list of the provisions that the recipient of the opinion letter has identified as significant. Others, however, feel that this phrase would just replace one laundry list—the provisions that may not be enforceable (prepared by the opinion giver)—with another laundry list—the provisions important enough to merit specific treatment in the opinion (prepared by the opinion recipient). See also the discussion in the New York Mortgage Loan Opinion Report.

Because California authorizes nonjudicial power of sale foreclosures, the opinion giver may be requested to specifically expand the reference to foreclosure in Paragraph 3.8(b)/(c) of Alternative 1 to include a sale under a power of sale in the deed of trust, although this is not necessary, because the concept of foreclosure is considered by California practitioners to include nonjudicial power of sale foreclosures. It may be appropriate to add a reference to remedies available under other specific collateral documents, such as an assignment of leases and rents, as long as

the language clearly states that it is subject to the qualifications and exceptions set forth in the opinion.

Alternative 2, known as the practical realization or traditional approach, has been heavily criticized for, among other things, its apparent ambiguity and subjectivity by the American College of Real Estate Lawyers (ACREL), 29 Real Prop Prob & Tr J at 588, and has fallen into disfavor in many quarters. On the other hand, the practical realization approach has been included in model forms developed in two New York bar reports:

- Tri-Bar 1998 Report, published in 53 Bus Law 591 (1998); and
- New York Mortgage Loan Opinion Report, published in 54 Bus Law 119 (1998).

The Maryland Bar Report, although recommending against the "practical realization" language, includes a sample clause that makes the comfort provided by the practical realization subject to the economic consequences of delay. See Special Joint Committee of the Section of Business Law and the Section of Real Property, Planning and Zoning of the Maryland State Bar Association, 2007 Report on Lawyers' Opinions in Business Transactions (Maryland State Bar Association 2007); the report can be found at the website listed in the Directory.

The approach preferred and recommended by the authors is Alternative 1, the ABA-ACREL approach.

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§8.87 L. Form: Choice-of-Law Qualification

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8.87-1 Choice-of-law qualification

[*Add one of the following three alternatives*]

[*Alternative 1: Assumes that law of opining jurisdiction governs*]

3.9. Choice of Law. The opinion in _ _[*e.g., Paragraph 2.4*]_ _ of this Opinion Letter is given as if the Law of the Opining Jurisdiction governs each Transaction Document, without regard to whether the Transaction Document so provides and without regard to any choice-of-law rules except as provided below in this paragraph. Although the preceding sentence excludes any opinion on the effectiveness of any governing law provision in the Transaction Documents, if a Transaction Document contains a governing law provision choosing the Law of the Opining Jurisdiction to govern the contract, the Opinion in _ _[*e.g., Paragraph 2.4*]_ _ of this Opinion Letter includes an Opinion (subject to the other qualifications in this _ _[*e.g., Paragraph 3*]_ _) that such governing law provision choosing the Law of the Opining Jurisdiction will be given effect under the choice-of-law rules of the Opining Jurisdiction; however, the Opinion in _ _[*e.g., Paragraph 2.4*]_ _ of this Opinion Letter does not include an opinion on what Law governs (a) if the Transaction Document contains a governing law provision choosing the Law of an Other Jurisdiction (as defined in the attached Glossary) or does not contain a governing law provision, or (b) to the extent that the opinion as to what Law governs requires a determination that the Law of the Opining Jurisdiction is not contrary to a fundamental policy of the Law of an Other Jurisdiction.

[*Alternative 2: Comprehensive choice-of-law opinion*]

3.9. Choice of Law. The enforceability by a California court (or by a federal court applying California's choice-of-law rules) of the choice-of-law provisions in the Transaction Documents that select the laws of the State of _ _[*name of state*]_ _ to govern the Transaction Documents (except that the laws of the State of California shall govern with respect to the creation, perfection, and enforcement of the liens, security interests, and encumbrances of the California Security Documents and the management, operation, disposition, and realization of the security of the California Security Documents) will be subject to the analysis and considerations described in qualification section of this opinion letter (the "choice of law analysis"). The choice-of-law analysis will be applied to the determination regarding whether or not each particular provision of the Transaction Documents will be governed by the laws of the State of _ _[*name of state*]_ _. Assuming that the State of _ _[*name of state*]_ _ has a substantial relationship to the parties or the transaction, then with respect to any particular issue presented to a court in the State of California, if the law of the State of _ _[*name of state*]_ _ would be chosen on such issue absent a choice of law provision, then the choice of _ _[*name of state*]_ _ law would be honored with respect to such issue. If the law of the State of California would be applied with respect to such issue absent a choice of law provision, but the application of the law of the State of _ _[*name of state*]_ _ to such issue would not be contrary to a fundamental policy of the State of California, then the choice of _ _[*name of state*]_ _ law would be honored with respect to such issue. If the law of the State of California would be applied with respect to such issue absent a choice of law provision, and the application of the law of the State of _ _[*name of state*]_ _ to such issue would be contrary to a fundamental policy of the State of California, then the choice of _ _[*name of state*]_ _ law would be honored with respect to such issue only if the court determines that the State of California does not have a materially greater interest than the State of _ _[*name of state*]_ _ in the resolution of such issue. Despite the foregoing, we have been informed and have assumed (and have no current actual knowledge of any facts to the contrary) that _ _[*conforms to actual facts/the following is illustrative and assumes a loan secured by a deed of trust on a single property in the State of California*]_ _ (a) the Lender has offices in the State of _ _[*name of state*]_ _, (b) the Lender's corporate headquarters is in the State of _ _[*name of state*]_ _, (c) the Transaction Documents were negotiated by persons representing the Lender in _ _[*name of state***]_ _, (d) the Transaction Documents will be executed by the Lender in the State of _ _[*name of state*]_ _, (e) the funding of the Loan will originate from the State of _ _[*name of state*]_ _, (f) the Transaction Documents require that Borrower make payments of principal and interest to Lender at its offices in _ _[*name of state*]_ _, (g) the Borrower's principal place of business is in the State of California, and (h) the Project is located in the State of California. Although it may be subject to an evidentiary hearing as described in the qualification section of this opinion, based on this information, it would be reasonable for a court applying California law to determine that the State of _ _[*name of state*]_ _ has a substantial relationship to the transaction contemplated by the Transaction Documents. Based on the**

foregoing, and subject to the choice of law analysis, though the issue is not entirely free from doubt and subject to the qualifications, assumptions, and analysis set forth herein, if the issue is properly presented and argued, a California court or a federal court sitting in California and applying California law should give effect to the governing law provisions in the Transaction Documents, and apply the substantive law of the State of _ _[*name of state*]_ _ to the extent provided in the Transaction Documents (except with respect to any issues relating to the one action and other antideficiency rules of the State of California, about which we express no opinion in this Opinion Letter), absent an overriding California public policy. Owing to the strong public policy underlying the one form of action and antideficiency laws in California and the interrelationship among the Transaction Documents _ _[*if applicable/ and any security documents to be recorded in states other than California (Other States' Security Documents)*]_ _, however, the type, location, and order of any actions taken by Lender in connection with the Transaction Documents _ _[*if applicable/and the Other States' Security Documents*]_ _ will significantly affect the extent to which the courts of California will enforce the choice-of-law provisions as they relate to the one-action and antideficiency laws. No opinion is provided with respect to which of the provisions in the Transaction Documents relate to creation, perfection, and enforcement or management, operation, disposition, and realization of the security, which are issues that will be a matter for determination by the reviewing court.

[*Alternative 3: Short form choice-of-law opinion*]

3.9. Choice of Law. Subject to the Choice-of-Law Analysis in qualification Paragraph _ _[*e.g., 3.10*]_ _ below, though the issue is not entirely free from doubt and subject to the qualifications, assumptions, and analysis set forth below, if the issue is properly presented and argued, a California court or a federal court sitting in California and applying California law should give effect to the choice-of-law provisions in the Transaction Documents that select the laws of the State of _ _[*name of state*]_ _ to govern the Transaction Documents (except that the laws of the State of California shall govern with respect to the creation, perfection, and enforcement of the liens, security interests, and encumbrances of the California Security Documents and the management, operation, disposition, and realization of the security of the California Security Documents) except with respect to any issues relating to the one action and other antideficiency rules of the State, about which we express do not opine herein, absent an overriding California public policy.

8.87-2 Single-issue choice-of-law opinion—usury

3.10. Usury Choice of Law. The California Usury Law (Article XV, Section 1, of the California Constitution) was enacted by a public vote in 1976. The California Usury Law provided for a 10 percent per annum interest rate ceiling for loans for personal, family, and household purposes and a potentially higher interest rate ceiling for all other loans in accordance with a formula tied to the Federal Reserve Bank Discount rate. More importantly the California Usury Law provides that loans made by certain lenders, for either a personal, family, or household use, or any other purpose, are subject to no ceiling whatsoever. Loans made or arranged by licensed real estate brokers and secured directly or collaterally by a lien on real property are also "exempt" from the interest rate restrictions. The California Usury Law also provides for the ability of the California Legislature to designate other lenders who would be exempt from the interest rate ceiling. The California Legislature has accepted this invitation to expand the list of exempt lenders from seven to approximately forty.

In light of the foregoing, the argument that the California Usury Law, and the subsequently enacted exemptions, constitute a "fundamental policy" under California law should not be viewed as persuasive. If California ever did have a fundamental policy of limiting interest rates for loans or forbearances, that time has long since passed. Therefore, a California court considering the issue of the enforceability of the choice-of-law provisions in the Transaction Documents as they relate to usury should hold that such choice is enforceable, since the interest of California in enforcing interest rate restrictions in the context of this Transaction should not be viewed as fundamental. See, *e.g. Petters Co. v BLS Sales, Inc.* (ND Cal, Aug. 26, 2005, No. 04-02160) 2005 US Dist Lexis 19730, citing pre-California Usury Law cases and stating "California courts have had the opportunity to determine whether California's prohibition on usury is fundamental public policy overriding a contractual choice-of-law provision. While they have never settled on a particular standard, they have allowed interest rates above the constitutional limit where there is a substantial relationship between the contract and the state which is referenced in the choice-of-law provision."

Should a California court determine that California's interest in this context is fundamental, in light of the vast amount of exemptions to the interest rate restrictions enacted by the California Legislature, such court should determine that California does not have a materially greater interest than the State of _ _[*name of state*]_ _ in the resolution of this issue. Therefore the choice-of-law provision with respect to the issue of usury should be enforceable.

Comment: The first sentence in Alternative 1 of Paragraph 3.9 follows Accord §10(b), as modified by ABA-ACREL Report ¶8. The second sentence in that Alternative 1 follows Accord §10(d)(i) as supplemented by ABA-ACREL Report ¶9.

Despite the wording in Alternative 1, the ABA-ACREL Report notes that it would "not be uncommon" for a real

estate secured transaction opinion to exclude any choice-of-law opinion, and that such opinions are often given as reasoned opinions, and are based on assumptions of factual matters having a bearing on the choice-of-law analysis and the opinion conclusion such as that set forth in Alternative 2. The choice-of-law analysis is described in §§8.62-8.63. Nevertheless, the ABA-ACREL Report would presume (in the absence of a contrary indication in the opinion letter such as that in Alternative 1) that the opinion giver has addressed certain aspects of choice of law, such as whether the opining jurisdiction has sufficient nexus to the transaction, whether another jurisdiction has a closer nexus, and whether the other jurisdiction has "materially a greater interest than the chosen state in the determination of the particular issue," citing Restatement (Second) of Conflict of Laws §187(2)(b) (1971). Such an opinion is included as Alternative 2 and would be included in the Choice of Law discussion in the qualification referred to in Alternative 3.

Alternatives 2 and 3 assume that (1) the agreement and note provide that the law of a state other than California will govern the interpretation and enforceability of such documents; (2) the California security documents (*i.e.,* deed of trust, assignment of leases and rents) are governed by the law of another state other than with respect to creation, perfection, and enforcement of the liens; and (3) there are other security documents securing the loan recorded or filed against property in states other than California (the "Other States' Transaction Documents"), which may or may not be true in any given transaction. See also Paragraph 2.9 in form 8.78-1 and the Comment. On choice of law, see §§8.60-8.66.

Paragraph 3.10 is an example of a single-issue opinion provision—limited in this instance to the issue of usury.

NOTE: The enforceability of forum-selection clauses is subject to a reasonableness test, but the clauses will generally be enforceable absent an overriding public policy concern. *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 131 CR 374.

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§8.88 M. Form: Additional Confirmation

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8.88-1 Additional confirmation

4. Legal Proceedings. We hereby confirm to Lender, pursuant to the request in Section _ _[*number*]_ _ of the Agreement, but without investigation, analysis, or review of court or other public records or our files, other than our litigation docket and information provided to us by the Client, that there are no actions or proceedings against the Client, pending or overtly threatened in writing, before any court, government agency, or arbitrator that (a) seek to affect the enforceability of the Agreement, or (b) except as disclosed in _ _[*the Agreement or an exhibit, annex, or schedule*/*an officer's certificate/a docket search*]_ _, come within _ _[*the objective standard established in the Agreement for disclosure of such matters*/*another objective threshold*]_ _.

Comment: If an explained opinion is to be provided, it may be included or referred to in this portion of the opinion letter. Include paragraph 4 if the opinion letter is to provide information on pending or threatened legal proceedings. This paragraph is derived from Accord §17 and the Illustrative Opinion Letter following the Accord. See also Accord §3(a)(i). On legal proceedings, see §§8.46-8.51.

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§8.89 N. Form: Use of This Opinion

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8.89-1 Use of this opinion

5. Use of This Opinion. The opinions expressed in this Opinion Letter are solely for Lender's use in connection with the Transaction for the purposes contemplated by the Transaction Documents. Without our prior written consent, this Opinion Letter may not be used or relied on by Lender for any other purpose whatsoever except (a) in connection with review of the Transaction by a regulatory agency having supervisory authority over Lender for the purpose of confirming the existence of this Opinion Letter, (b) in connection with the assertion of a defense as to which this Opinion Letter is relevant and necessary, or (c) in response to a court order.

[*If applicable, add the following option*]

[*Option: may be delivered or relied on by others*]

Despite any foregoing paragraph, Lender may deliver a copy of this Opinion Letter to _ _[*name of: lending bank/syndicate participants/subsequent purchasers/rating agency/other*]_ _ **in connection with** _ _[*state purpose*]_ _**, and such person or persons may rely on this Opinion Letter as if it were addressed and had been delivered to** _ _[*it/them*]_ _ **on the date of this Opinion Letter.**

Very truly yours,

__[*Signature*]__
_ _[*Typed name*]_ _

Comment: Paragraph 5.1 is adapted from Accord §20. If others are permitted to receive copies of or rely on the opinion letter, use the optional language.

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§8.90 O. Form: Glossary

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8.90-1 Glossary

As used in the Opinion Letter to which this Glossary is attached, except as otherwise defined in the Opinion Letter, the following terms (whether used in the singular or the plural) shall have the meanings indicated:

Accord: **The "Accord" is part of the Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association, 47 Bus Law 167 (1991) (reprinted in 29 Real Prop Prob & Tr J 487 (1994)) (referred to below as the "ABA Business Law Report").**

ABA-ACREL Report: **Report on Adaptation of the Legal Opinion Accord of the Section of Business Law of the American Bar Association for Real Estate Secured Transactions of the Section of Real Property, Probate & Trust Law of the American Bar Association and the American College of Real Estate Lawyers, 29 Real Prop Prob & Tr J 569 (1994).**

Actual Knowledge: **With respect to the Opinion Giver, the conscious awareness of facts or other information by the Primary Lawyer or Primary Lawyer Group.**

Client: **The party or parties to the Transaction (including predecessor entities when relevant) for which the Opinion Giver provides legal representation.**

Collateral: **Collectively or individually, all Real Property described in the Security Documents and all Personal Property described in the Security Documents, for which provision is made by the Security Documents for a lien or security interest, unless a different meaning is given in the Transaction Documents.**

Constituent Documents: **The articles or certificate of incorporation, bylaws, partnership documentation, or similar organization documents of the Client.**

Court Orders: **Court and administrative orders, writs, judgments, and decrees that name the Client and are specifically directed to it or its property.**

Law: **The statutes, the judicial and administrative decisions, and the rules and regulations of the government agencies of the Opining Jurisdiction, including its Local Law (but subject to any limitations on coverage of Local Law set forth in the Opinion Letter to which this Glossary is attached).**

Local Counsel: **An attorney licensed in a state with a relationship to a transaction who is generally not the primary counsel for a client or an opinion recipient, but is engaged to render advice with respect to certain aspects of a transaction or to provide certain opinions concerning (a) a client who was formed or transacts business in the state or (b) elements of the transaction that concern the state.**

Local Law: **The statutes and ordinances, the administrative decisions, and the rules and regulations of counties, towns, municipalities, and special political subdivisions (whether created or enabled through legislative action at the Federal, state, or regional level—*e.g.*, water agencies, joint power districts, Maine Turnpike Authority, Southern California Rapid Transit District, Port Authority of New York and New Jersey), and judicial decisions to the extent that they deal with any of the foregoing.**

Opining Jurisdiction: **A jurisdiction whose applicable Law is addressed by the Opinion Giver in the Opinion; if there is more than one such jurisdiction (*e.g.,* the United States and a particular state), the term refers collectively to all.**

Opinion: **A legal opinion that _ _[*includes a declaration that it is governed by the Accord and*]_ _ is rendered by the Opinion Giver to one or more persons involved in the Transaction other than the Client.**

Opinion Giver: **The lawyer or legal organization rendering the Opinion.**

Opinion Letter: **The document setting forth the Opinion that is delivered to and accepted by the Opinion Recipient.**

Opinion Recipient: **The addressee or addressees of the Opinion Letter.**

Other Agreements: **Contracts, other than the Transaction Documents, to which the Client is a party or by which it or its property is bound.**

Other Counsel: **A lawyer or legal organization (other than the Opinion Giver) providing a legal opinion pertaining to particular matters concerning the Client, the Transaction Documents, or the Transaction (a) directly to the Opinion Recipient or (b) to the Opinion Giver in support of the Opinion.**

Other Jurisdiction: **The jurisdiction whose law a Transaction Document provides will govern that contract, if not the Opining Jurisdiction.**

Personal Property: **Property or rights and interests in property treated under Law as personalty or otherwise not as Real Property.**

Primary Lawyer:

(1) The lawyer in the Opinion Giver's organization who signs the Opinion Letter;

(2) Any lawyer in the Opinion Giver's organization who has active involvement in negotiating the Transaction, preparing the Transaction Documents, or preparing the Opinion Letter; and

(3) Solely as to information relevant to a particular opinion issue or confirmation regarding a particular factual matter (*e.g.,* pending or threatened legal proceedings), any lawyer in the Opinion Giver's organization who is primarily responsible for providing the response concerning that particular opinion issue or confirmation.

Primary Lawyer Group: **All Primary Lawyers when there is more than one.**

Public Authority Documents: **Certificates issued by the Secretary of State or any other government official, office, or agency concerning a person's property or status, such as certificates of corporate or partnership good standing, certificates on tax status, certificates on Uniform Commercial Code filings, or certificates on title registration or ownership.**

Real Property: **Property or rights and interests in property treated under Law as real property, including fixtures.**

Rents: **"Leases," "rents," "issues," and "profits," as such terms are used in California Civil Code §2938.**

Security Documents: **Mortgages, deeds of trust, security agreements, assignments of leases, rents, or both (regardless of whether stated as absolute or as a security assignment), or similar instruments that provide for the creation of a lien on or security interest in Collateral to secure the Client's obligations under the Transaction Documents.**

Transaction: **The loan, secured by Real Property, made by the Opinion Recipient to the Client.**

Transaction Documents: **The contract documents setting forth the principal terms of the Transaction addressed by the Opinion, including the Security Documents and other contracts ancillary to the Security Documents that are explicitly addressed by the Opinion. Unless otherwise included by express statement in an Opinion Letter, contracts of persons other than the Client (such as guaranties and letters of credit) are not included in the term Transaction Documents.**

Comment: See Accord §21.

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9

Construction Loans

Anne E. Klokow

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§9.1 I. CONSTRUCTION LOANS

The purpose of a construction loan is to provide the necessary financing to pay for the costs associated with developing and constructing projects on real property. The construction loan often includes a land draw component if the borrower is also acquiring the land. The construction lender will almost always require that the loan be secured by a first lien deed of trust on the real property, and a first priority security interest in the various land use entitlements and governmental approvals that give the borrower the right to develop the property and in the engineering, architectural, and construction contracts, plans, and specifications prepared by the project architect and engineer. The major difference between construction loans and permanent loans is that the permanent loan is usually funded entirely at closing for the purpose of either purchasing real property or refinancing an existing loan secured by real property. In contrast, construction loan proceeds are disbursed by the lender throughout the course of constructing the project in accordance with the terms and conditions of a loan agreement between the borrower and lender. Among other things, the loan agreement contains the loan closing conditions, which usually also include the conditions that must be satisfied before the lender is obligated to make the initial loan advance, subsequent advances during construction, and the final disbursement. The amount of the advance is tied to a construction budget submitted by the borrower and approved by the lender before the loan closing. The construction loan agreement also contains the guidelines for constructing the project in accordance with the plans and specifications prepared by the engineer and architect and approved by the lender before the closing. Any changes to the project plans and specifications after the lender has approved them are generally subject to the lender's prior approval.

For a discussion of the issues a lender must face in dealing with the mechanics' lien and stop notice rights of persons furnishing goods and services to a private construction project, including the rights of contractors, subcontractors, and material suppliers on the rights and remedies of a construction lender, see California Mechanics' Liens and Related Construction Remedies, chap 11 (3d ed Cal CEB 1998).

On permanent loans (*i.e.,* those that do not involve the disbursement of proceeds over time but that are typically funded at closing to either refinance existing debt or acquire property), see chaps 2-7.

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II. NEGOTIATING CONSTRUCTION LOAN COMMITMENT

§9.2 A. Construction Loan Commitment Compared to Permanent Loan Commitment

The three main functions of a construction loan commitment are to

- describe the major loan terms that will be incorporated into the final loan documents evidencing and securing the construction loan;
- provide a checklist of the closing conditions that includes both the conditions for closing the loan and the conditions that must be satisfied before the lender is obligated to make available the initial advance under the construction loan; and
- memorialize the parties' respective rights and obligations from the time the commitment is executed until the loan is closed.

A major difference between construction and permanent loan commitments is the additional due diligence the construction lender must perform. For example, the construction lender must confirm that all governmental entitlements and other approvals for the construction of the project have been obtained. The construction lender must also receive evidence that the proposed project can be completed within the time frame and for the cost projected by the borrower. The construction lender also needs evidence that the stabilized value of the completed project can be achieved by the maturity date of the loan. The "stabilized value" is the projected value of the project after construction is completed, and is the value determined once a certain occupancy level has been achieved and annual reoccurring net operating income provides a minimum debt service coverage ratio established by the lender. The stabilized value is often determined by the appraiser.

EXAMPLE: The stabilized value might be determined at the time the occupancy rate is 90 percent and the debt service coverage ratio is 1.25 to 1.00.

The construction loan commitment typically contains the following construction related due diligence conditions that must be satisfied before closing:

- Evidence that the project can be built by the scheduled completion date and for the total budgeted construction costs;
- Evidence that the necessary land use entitlements, permits, and approvals (both governmental and private) have been obtained, or will be attainable, by the borrower;
- If the improvements will be leased after construction is completed, evidence that the project will be leased up within the time projected and for the pro forma rental rates needed to achieve the lender's minimum debt service coverage ratio requirements;
- If the improvements will be sold upon completion, evidence that the projected net sales proceeds will be sufficient to repay the loan on or before the scheduled maturity date; and
- If the project is an expansion or remodel rather than new construction, evidence that the proposed construction work can be performed without triggering any tenant termination rights and that the rental income stream generated from existing leases will not be abated or reduced during the construction period.

Careful attention must be given to the negotiation of these conditions and the rest of the loan agreement as this document guides the conduct of the lender and borrower throughout the construction process.

For a detailed guide to drafting and negotiating loan commitments, generally see chap 2.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.3 B. Basic Loan Terms Unique to Construction Loan Commitment

§9.3 B. Basic Loan Terms Unique to Construction Loan Commitment

A construction loan commitment sets forth the basic economic terms on which the lender will make the loan and, like the permanent loan commitment, includes key provisions that will ultimately be incorporated into the final loan documents. In addition to the basic loan terms discussed in §2.3, the construction loan commitment will typically also include the following:

- A maximum loan amount, often tied to a loan-to-value ratio (for definition, see §1.44) and loan-to-cost limitations (see §9.4);
- Outside dates by which construction of the project must be commenced and completed (see §9.5);
- Maturity date extensions rights;
- Borrower's equity requirements;
- Interest reserve requirements;
- Completion guaranties;
- Preleasing or presales requirements; and
- Permanent take-out financing requirements.

PRACTICE TIP: As a practical matter, not all of the loan terms and conditions can be included in the loan commitment. Therefore, it is the role of both lender's and borrower's counsel to make sure that all economic terms critical to their respective clients are incorporated into the loan commitment to avoid uncertainty, disagreement, and delays during the loan documentation stage.

On construction lender's rights and remedies in a nonconsensual workout, see California Mortgages, Deeds of Trust, and Foreclosure Litigation §§10.43-10.64 (4th ed Cal CEB 2009).

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§9.4 1. Maximum Loan Amount

The loan commitment will typically provide a maximum dollar amount that the lender will fund to pay for the following:

- Acquiring the property if the borrower is not already the owner;
- "Soft costs" that the borrower incurs before and after the loan closing in connection with the acquisition and development of the property. "Soft costs" are fees and costs that are not directly related to the onsite construction of the improvements and include inspection fees, escrow fees, architectural and engineering fees, survey fees, accounting and legal fees, appraisals and closing costs, and the cost of reports;
- Hard and soft costs associated with the development and construction of the project that are disbursed after the loan closes but that may include costs incurred by the borrower before loan closing. "Hard costs" are the material and labor costs to construct the improvements;
- Tenant improvement costs; and
- Carrying costs needed to operate and maintain the property until either (1) the project reaches break-even (or the time the then current net operating income for the property (gross rental income less operating expenses), usually as determined by lender, equals or exceeds the then current debt service payment on the loan) or (2) in the case of for-sale projects, the project is sold and the loan is repaid.

All of these costs will be set forth in a construction budget to be agreed on by the borrower and the lender before closing and disbursed throughout the course of construction. Sometimes the budget includes a line item for tenant improvement work. Notwithstanding the total projected acquisition and development costs of the project, the loan commitment will usually contain a maximum loan amount tied to either or both the stabilized value of the property and the total construction costs. This limitation is usually expressed in terms of a loan-to-value ratio (for definition, see §1.44) and/or loan-to-cost ratio (for definition, see §1.43A). Both permanent and construction lenders typically limit the maximum funds they will loan by using both loan-to-value and loan-to-cost ratios. The construction lender will typically calculate the loan-to-value using the value of the property after completion of construction or the stabilized value of the property (see discussion in §9.2) rather than the actual value of the unimproved land.

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§9.5 2. Commencement and Completion Dates

The construction commencement and completion dates are typically set out by the lender in the loan commitment. These dates are often the subject of negotiation because the lender's and borrower's interests almost always diverge. If the borrower is not in a position to commence construction immediately, borrower's counsel should confirm with the borrower that the commencement date proposed by the lender affords the borrower adequate time to

- obtain all necessary building permits and other governmental approvals and entitlements necessary to commence construction;
- finalize the plans and specifications for the project with the project architect and engineer; and
- finalize the construction contract with the general contractor and confirm that the general contractor is able to commence construction by the proposed commencement date.

The lender often selects an outside completion date that gives the borrower adequate time to complete construction but that also precedes the construction loan's maturity date by sufficient time to permit the borrower to lease the property, construct tenant improvements, and achieve stabilization by the maturity date.

If the borrower intends to start construction before recordation of the lender's deed of trust, the borrower must alert both the lender and the title company issuing the lender's title insurance policy before construction starts. The lender will, at a minimum, require additional title policy protection against any mechanics' liens that may take priority to the deed of trust as a result of preclosing construction work. The title company typically requires a mechanics' lien indemnity from the borrower or other creditworthy third party as a condition to providing the lender with the necessary mechanics' lien coverage. Some lenders may not permit the borrower to commence construction before loan closing and others may require that the preclosing construction work be contained in a separate construction contract. See California Mechanics' Liens and Related Construction Remedies, chap 11 (3d ed Cal CEB 1998).

The construction loan agreement usually includes both the conditions for closing the loan and the conditions for the first disbursement. Often, all of the conditions set forth in the lender's standard loan agreement will not be completed before the loan records. In many instances, the borrower will not have pulled all of the necessary permits by loan closing and the general contractor may not have final subcontracts for all of the work. In some cases, the general construction contract may still be in the negotiation stage.

PRACTICE TIP: Borrower's counsel should make sure that the lender is aware of any conditions that will not be satisfied before loan closing, and the loan agreement should be amended to reflect any items that the lender has agreed to defer to a later date.

PRACTICE TIP: Borrower's counsel should confirm that the borrower is confident that the project can be completed by the proposed outside completion date, including additional time for inevitable, but not always foreseeable, construction delays. If the lender's proposed date is not consistent with the borrower's estimated completion date, then borrower's counsel should seek to negotiate a later completion date that allows adequate time for completion. The lender's willingness to negotiate a later completion date will be affected by its overriding concern that there be ample time after construction is completed to achieve stabilization and close the permanent take-out financing before the construction loan matures. The borrower should not agree to an unrealistic completion date in the loan commitment, because the loan agreement will undoubtedly provide that the lender has no further obligation to fund after the outside completion date.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.6 3. Extensions of Maturity Date

§9.6 3. Extensions of Maturity Date

When considering the commencement and completion dates, borrower's counsel should discuss with the borrower whether there is sufficient time after the scheduled completion date to lease the property and obtain permanent financing to pay off the construction loan before it matures. Rather than extending the original maturity date, the lender often offers the borrower the right to extend the maturity date for one or more short periods of time. The right to extend, and the conditions for exercising that right, are usually set forth in the loan commitment and often require the following:

- Payment of an extension fee for each extension;
- Completion of construction;
- The absence of any outstanding loan defaults; and
- Existence of a certain minimum debt service coverage ratio (see definition in §1.36) be achieved as a condition to each extension.

PRACTICE TIP: Borrower's counsel should carefully review with the borrower how the minimum debt service coverage ratio is calculated. In calculating the ratio, the lender may assume factors such as an interest rate that may be greater than the actual interest rate, an assumed vacancy rate that may be higher than the actual vacancy rate, and other factors that affect whether the debt service coverage requirements can be met. If the borrower is concerned that it may not be able to satisfy the debt service coverage ratio, borrower's counsel should determine if the lender will allow the borrower to partially pay the loan down to an amount that satisfies the ratio. Borrower's counsel should also clarify whether "completion of construction" includes completion of tenant improvements or just completion of the shell. If the latter, tenant improvements should be specifically excepted from the conditions for obtaining the extension.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.7 4. Completion Guaranty

§9.7 4. Completion Guaranty

If the lender requires a completion guaranty, the basic terms should be set forth in the loan commitment. See §§9.30A-9.30L for a detailed discussion of completion guaranties.

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§9.8 C. Closing Conditions and Due Diligence Items

In addition to the closing conditions and due diligence items set forth in a permanent loan commitment (see §§2.4-2.5), the construction loan commitment typically includes additional due-diligence-related closing conditions:

- Property appraisal, often including an "as is" value and a stabilized value necessarily based on assumptions including projected rental rates, operating expenses, vacancy rates, and other economic factors;

PRACTICE TIP: The appraisal is usually obtained and reviewed internally by the lender without the involvement of either counsel.

- Building permits and other land use entitlements and approvals, including any development agreements with the city or other governmental agency (see §9.9);
- Permanent financing commitment and a tri-party agreement between the construction lender, permanent lender, and borrower;
- Payment and performance bonds (see California Mechanics' Liens and Related Construction Remedies, chaps 9-10 (3d ed Cal CEB 1998));
- Approval of architect, engineer, and general contractor;
- Approval of final plans and specifications;
- Approval of engineering agreement, architect's agreement, and general construction contract (on construction contracts, see California Construction Contracts, Defects, and Litigation (Cal CEB 2008));
- Approval of construction budget;
- Evidence of borrower's equity;
- Issuance of lender's LP-10 title insurance policy with mechanic's lien coverage, zoning endorsement, and other construction-related endorsements (see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997));
- Borrowing resolutions and borrower's organizational documents (see §1.66);
- Evidence of compliance with any covenants, conditions, or restrictions restricting the development of the property;
- Opinion letter from borrower's counsel (see chap 8);
- Estoppel certificates and subordination, nondisturbance, and attornment agreements from any existing tenants (see Retail Leasing: Drafting and Negotiating the Lease, chaps 41, 44 (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease, chaps 27-28 (Cal CEB 1996));
- Escrows of funds; and
- Letters of credit.

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§9.9 D. Land Use Entitlements

Lender's counsel typically reviews all land use entitlements and governmental approvals needed to develop the property. Although the lender often hires a consultant to review the entitlements and permits, lender's counsel should, at a minimum, make sure that the entitlements are vested in the name of the borrower. Frequently, the borrower is a relatively new entity (see §1.66) that may not even be formed until the closing. Thus, the entitlements may be in a related entity's name rather than the borrower's name. If so, lender's counsel should require assignments of any such entitlements to the borrower as a condition to closing the loan. Borrower's counsel should coordinate delivery of the evidence needed to satisfy the lender and its counsel that the project is adequately zoned to permit the intended construction and use of the property and that all necessary permits and governmental approvals have been obtained. On land use and zoning requirements generally, see California Land Use Practice (Cal CEB 2006).

If there is a development agreement with a city or other governmental agency, the lender should require an estoppel certificate from such governmental agency that states, at a minimum, that the development agreement has not been amended and is in full force and effect, that the borrower is not in default, and that the borrower has completed its obligations under the development agreement. To the extent the obligations may not be satisfied before closing, the lender must evaluate whether the costs associated with satisfying the unfulfilled obligations are included in the budget and whether the borrower has the ability to perform any unsatisfied obligations or conditions in a timely manner to avoid any delay or impairment of the project's completion. If performance of certain conditions are dependent on third parties, then the lender must also obtain assurances from those third parties that they have the ability to timely perform.

Additionally, the lender will require a collateral assignment of the borrower's rights under the development agreement. Depending on the mortgagee protection clauses in the development agreement, the lender may also need the local governmental agency's consent to the collateral assignment or may need to notify the agency in writing of the collateral assignment. On development agreements generally, see California Subdivision Map Act and the Development Process, chap 7 (2d ed Cal CEB 2001).

PRACTICE TIP: The lender's counsel will prepare the form of estoppel or comment on the estoppel form provided by the governmental agency, but the borrower or its counsel is usually responsible for negotiating the terms of the estoppel and obtaining the necessary signatures from the agency. In order to avoid delays in closing the loan, any development agreements should be reviewed early in the process to determine if the consent of the agency is required, because this can be a time-consuming process.

The lender may require bifurcation of the development agreement if it covers more property than the project serving as the lender's collateral. The lender will want to make sure that (1) the failure of the borrower to perform its obligations with respect to the other property covered by the development agreement will not adversely impact the borrower's rights relating to the development of the project, and (2) if the lender enforces the collateral assignment, it will not inadvertently assume any obligations accruing before its enforcement of the assignment or that are attributable to the other property covered by the development agreement.

If there is a conditional use permit or other special permit, the lender and its counsel will review the conditions and require evidence that all conditions precedent have been, or are capable of being, satisfied before closing. The lender will also require evidence that the project, and the plans and specifications, have received all necessary final approvals and that the building permits have been issued (or if not actually issued, that all conditions for the issuance of all permits have been satisfied). On conditional use and special permits (variances), see California Land Use Practice, chaps 6-7.

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III. THE LOAN AGREEMENT

§9.10 A. Purpose of Loan Agreement

The loan agreement sets forth the terms and conditions on which the lender will advance the loan proceeds for the development and construction of the borrower's proposed project and, if the loan contains a land draw, for the acquisition of the real property on which the project will be built. Careful attention should be given to the negotiation of the loan agreement because it is a document that governs the conduct of the lender and borrower throughout the construction process. Unlike many provisions in the other loan documents that take effect only if there is a default, a casualty, condemnation, or other contingent event that might never occur, the borrower and lender will refer frequently to the loan agreement during the construction process. The loan agreement covers all areas of construction, including the following:

- Conditions that the borrower must satisfy before the lender is obligated to close the loan;
- Conditions that the borrower must satisfy before the lender is obligated to advance loan proceeds, which are typically divided into the following categories:
- Initial advance of loan proceeds, which usually includes a land draw if the property is being acquired and reimbursement of certain soft costs incurred before closing, such as architect and engineer fees and costs, the lender's loan fee, broker's commissions, and other loan closing costs incurred by the borrower;
- Subsequent advances made during the course of construction; and
- Final advance made on completion of construction;
- Borrower's covenants relating to construction, including the following:
- The obligation to commence and complete construction by certain dates;
- The obligation to construct the project in accordance with the plans and specifications, the construction budget, and the construction schedule, all of which the lender must approve before the closing;
- Covenants relating to the permanent commitment, if applicable;
- Covenants relating to the operation of the property, including leasing restrictions imposed by the lender;
- The borrower's obligation to contribute funds at closing and after closing in order to keep the loan "in balance";
- Events triggering a loan default; and
- The lender's remedies if a default occurs.

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§9.11 B. Basic Form

The form construction loan agreement in §§9.32-9.41 contains provisions generally favoring the lender. The agreement incorporates exhibits for the legal description of the property (Exhibit A, §9.42), a description of the improvements and plans (Exhibit B, §9.43), the approved budget (Exhibit C, §9.44), schedule of loan documents (Exhibit D, §9.45), and tenant leases (Exhibit E, §9.46). Sections 9.12 through 9.30 explain the purpose of selected provisions from the lender's perspective and explain which provisions tend to be negotiable.

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C. Drafting and Negotiating Considerations for Loan Agreement

§9.12 1. Preexisting Loan Commitment

Counsel engaged to negotiate the construction loan agreement and related loan documents should first determine if the borrower and lender have signed a loan commitment, loan application, or other less formal term sheet, setting forth loan terms agreed to by the lender and the borrower before counsel's engagement. The borrower's counsel must confirm that the loan agreement accurately and completely reflects the terms of any existing loan commitment, loan application, or term sheet.

If the parties have entered into a loan commitment, a few lenders, concerned that the loan agreement may not cover all of the terms and conditions contained in the loan commitment, require that the commitment remain in full force and effect even after the execution of the loan agreement and loan closing. To avoid possible discrepancies between the loan commitment and the loan agreement, the better practice is to supersede the commitment with the loan agreement.

In such event, counsel should take care that all terms and conditions in the loan commitment that apply after loan closing are incorporated into the loan agreement. This eliminates the need to consult two different documents to ascertain the parties' rights and obligations.

During preparation of the loan documents, the borrower may attempt to renegotiate provisions previously agreed to in the loan commitment. The lender usually resists making changes to the loan documents when the applicable provisions have already been negotiated in the loan commitment. Often the major loan terms set forth in the loan commitment have been approved by the lender's senior management or loan approval committee. The loan officer or other individual negotiating the loan on behalf of the lender may not be free to renegotiate terms in the loan commitment without obtaining the approval of senior management or the loan committee.

PRACTICE TIP: Many lenders encourage the borrower's counsel to convey comments by making written comments, either by marking the changes in the margins of the draft loan documents or, if the drafts have been sent by electronic mail, by typing the proposed changes and comments into the loan documents. It is often helpful to provide the specific alternative language for the lender and its counsel to consider, rather than a general comment. Comments requiring significant redrafting are better left to lender's counsel to use the lender's own language. Lender's counsel may have limited authority to make revisions to the lender's loan agreement without consulting with the lender, and generally lender's counsel will, at a minimum, first discuss proposed revisions and comments of a business nature with the lender. Written comments usually make this internal review process by the lender more efficient.

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§9.13 2. Payment, Maturity Date, Extension

Although the promissory note contains the specific terms for repayment of the loan (see chap 3), the loan agreement usually sets out the maturity date and any rights to extend it. These provisions are often negotiated at the loan commitment stage. On maturity extensions and the lender's requirements, see §9.6.

PRACTICE TIP: Although the terms of the construction promissory note are beyond the scope of this chapter, interest is often a variable rate but can be fixed. Debt service payments are typically interest-only during the construction phase unless there is a permanent loan conversion feature. The construction lender is providing interim construction financing that it expects will be repaid with permanent take-out financing once the project is complete and has either been sold or reached stabilization (*i.e.,* the project is leased to tenants who are in occupancy and paying rent at rates generating income sufficient to meet the permanent lender's debt service coverage ratio (see §9.2)). This means the loan term is usually only long enough to build the project and either sell it or lease it up.

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§9.14 3. Prepayment Rights

Construction lenders typically permit prepayment of the principal portion of the construction loan in full or in part without charging a prepayment premium. This may not be the case, however, if the construction loan has a permanent conversion feature. The lender will usually require advanced written notice from the borrower of the intent to prepay. Paragraph 1.4 of the loan agreement (see §9.32) clarifies that the loan is not a revolving credit facility (enabling the borrower to pay down and reborrow principal throughout the loan term) by expressly providing that the borrower may not reborrow any amounts that are prepaid.

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§9.15 4. Interest Reserve and Application of Net Operating Income to Accrued Interest

Paragraph 1.5 of the loan agreement (see §9.32) confirms that the construction budget approved by the lender and attached to the loan agreement as Exhibit C (see §9.44) reflects estimated construction costs based on a certified cost breakdown prepared by the borrower and submitted to the lender during the loan closing process. The approved construction budget also contains a line item referred to as the "interest reserve," which represents the loan proceeds that are reserved for the payment of the interest estimated to accrue during the loan term. The amount reserved takes into account income generated from the project both during and after the construction period that will be applied to the payment of interest first, before funds are disbursed from the interest reserve. The lender is authorized to disburse from the loan proceeds, monthly on the payment due date, an amount equal to the interest due under the promissory note after payment of net income generated from the property. The funds are deemed disbursed from the interest reserve even though the disbursement is accomplished by a book entry rather than an actual disbursement of cash, and interest begins to accrue at the note rate on funds so disbursed.

Most lenders, before making any disbursement from the interest reserve, require the borrower to first pay the lender any net operating cash flow derived from the property that is credited to interest due and payable. Borrower's counsel should review the definition of "net operating income" or "net cash flow" with the borrower to make sure that the lender's standard definition is workable for the particular project. Paragraph 1.5 (see §9.32) allows the lender to approve the expenses that can be deducted from gross income for purposes of calculating net operating cash flow or net operating income.

PRACTICE TIP: Borrowers typically prefer not to seek the lender's approval of every operating expense that is deductible from gross income. However, most lenders will not agree to a broad deduction of "reasonable and necessary" operating expenses, because that gives the borrower too much discretion to apply project income to expenses that the lender may not consider reasonable or necessary. The lender's willingness to negotiate this provision will depend in part on the sophistication and reputation of the borrower. The more the lender trusts the business judgment of the borrower, the more flexibility it will afford the borrower. If the borrower wants assurances that it will be able to deduct certain known expenses, borrower's counsel should seek to identify those expenses and obtain the lender's preapproval of them.

Paragraph 1.5 of the loan agreement also requires that any excess income generated from the property after accrued interest on the note has been paid be deposited with the lender on a monthly basis and held as additional security for the repayment of the loan. To comply with the security-first aspect of the one-action rule (see CCP §726; see also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 4 (4th ed Cal CEB 2009)), the borrower grants a security interest in the deposited funds to the lender. Before an event of default, the lender can use the funds to pay interest on the loan. After an event of default, the lender may apply the funds to the debt.

PRACTICE TIP: Depending on the economics of the transaction, including the financial strength of any guarantors, the borrower may be able to negotiate the right to retain any excess income derived from the project after the payment of operating expenses and accrued interest on the loan. Any agreement by the lender allowing the borrower to distribute net operating income from the project to the borrower's principals will, at a minimum, be conditioned on there being no defaults under the loan documents. The lender must have the right to apply all rents and other income toward the debt from and after the occurrence of a default.

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§9.16 5. Loan Fees and Exit Fees

The loan agreement typically describe the amount of the loan fees payable to the lender by the borrower. For form, see paragraph 1.7 in §9.32. The agreement should specify which fees are nonrefundable, even if the loan does not close. The terms for payment and retention of loan fees are usually negotiated at the loan commitment stage. If the borrower's counsel was not involved in negotiating the commitment, care should be taken to make sure the borrower understands when the fees become nonrefundable because this will be a sensitive issue if the loan does not close. See Comment in §9.32 for discussion of the characterization of nonrefundable fees as liquidated damages. If the lender requires that a legal opinion be rendered by borrower's counsel, these fees need to be considered in deciding whether an opinion can be given that the loan is nonusurious. (See chap 8 on legal opinions.)

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§9.17 6. Loan Documentation and Security

A commercial construction loan is evidenced by the borrower's promissory note (on promissory notes, see chap 3) and is usually secured by the following:

- First construction deed of trust encumbering the land and all improvements whether existing or to be constructed on the land, any appurtenant easements and property rights, including access easements (on deeds of trust, see chap 4);

NOTE: A construction deed of trust must satisfy the requirements of CC §3097(j). For discussion, see note in §4.15.

- Security agreement (which may be a separate document or included within the deed of trust), granting a security interest in all construction materials, equipment, development agreements, and other personal property relating to the construction of the improvements and the personal property used in connection with the property or located at the property (on security agreements, see chap 7);
- Assignment of leases and rents absolutely assigning to the lender all of the rents, income, and profits derived from the property (on assignments of rent, see chap 5);
- Collateral assignment of the design professional's contract, plans and specification and design professional's agreement and consent to assignment, assigning the project architect's contract and the plans and specifications to the lender as additional security for the loan (see §9.46);
- Collateral assignment of the construction contract and permits and contractor's agreement and consent to assignment, assigning the construction contract and permits to the lender as additional security for the loan (see §9.47);
- Repayment guaranty pursuant to which one or more persons or entities guarantees repayment of the loan (on guaranties generally, see chap 6);
- Completion guaranty (see §§9.30A-9.30L; for form, see §9.49; on guaranties generally, see chap 6);
- Environmental indemnity agreement pursuant to which the borrower and any guarantors indemnify the lender for losses incurred by the lender as a result of the environmental condition of the property (see chap 5A); and
- Collateral assignment of purchase contracts and earnest money deposits, if the improvements are to be sold upon completion of construction.

For form loan agreement provision describing the loan documents to be executed that evidence and secure the loan, see paragraphs 1.7 through 1.9 in §9.32.

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§9.18 7. Borrower Representation and Warranties

The loan agreement contains a number of warranties and representations primarily relating to the borrower's

- formation;
- authority to sign the loan documents and perform its obligations under the loan agreement;
- financial condition;
- ability to construct the project in accordance with the approved plans and all governmental requirements; and
- ability to lease and operate the project on completion of construction.

Borrower's counsel should discuss each of the representations with the borrower to ensure that they are in fact true and correct. The lender's due diligence performed before the loan closing will serve to confirm the accuracy of most of the borrower's representations. The borrower should be warned that the warranties and representations are usually continuing in nature and must be true and correct throughout the term of the loan as a condition to obtaining subsequent loan advances. For form representations and warranties, see §9.33.

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§9.19 8. Delivery of Documents

The loan agreement details the conditions precedent to the loan closing. For form provision, see §9.34. Paragraph 3.1 requires the borrower to deliver at closing the loan documents executed by the borrower and any third parties (such as the architect, engineer, and the general contractor), final plans and specifications that have been approved by all necessary governmental agencies and the lender, and executed construction contracts, including the architect's agreement, the general construction contract, the engineer's agreement, any construction management agreements, and the major subcontracts.

PRACTICE TIP: The lender often reviews the construction contracts internally without the assistance of counsel. Lender's counsel typically reviews the construction-related contracts only to the extent required to effect an accurate collateral assignment of them to the lender. If any contracts are not in the name of the borrower (as is sometimes the case, for instance, when the borrower is a newly formed entity), then the lender will require that the contracts be assigned to the borrower with the consent of the other contracting party being obtained if required by the terms of the contract. The lender will also require that the general construction contract have a guaranteed maximum or fixed price to ensure that the project can be completed for the costs set forth in the approved budget.

PRACTICE TIP: Although the loan agreement may require the lender's review and approval of all subcontracts, the lender may be willing to limit its review to major subcontractors (*i.e.,* those subcontractors with contracts in excess of a certain dollar amount).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.20 9. Conditions Precedent to Initial Advance

§9.20 9. Conditions Precedent to Initial Advance

Paragraph 4.1 of the loan agreement (see §9.35) sets forth the conditions precedent to the lender's obligation to fund the initial construction loan advance. The initial advance is usually made at the loan closing and typically covers payment or reimbursement of the borrower's acquisition and development costs, including a "land draw." A "land draw" is used to pay the purchase price for the land if the borrower acquires the land at closing. If the borrower already owns the land, the land draw is paid directly to the borrower to reimburse the borrower's cost to buy the land, if there is no debt on the property, or to pay off any outstanding acquisition and development loan encumbering the land. An acquisition and development loan is obtained by the borrower to purchase the land and pay for initial development costs, such as the architect's fee for preparing the plans and specifications, engineering fees, and permit fees. The cost of the land will not be reimbursed to the borrower through the land draw if the land value constitutes all or part of the borrower's equity contribution (see §9.23).

PRACTICE TIP: Customarily, lender's counsel prepares a closing checklist setting forth each of the conditions to closing the loan and to funding the initial advance, if it is being made at closing. This closing checklist can be an extremely helpful reference tool. See §9.30 for form construction loan closing checklist. It is helpful to identify which party is responsible for preparing or delivering the particular closing item. The checklist should be consistently updated to provide the current status of each condition. Early in the loan closing process, borrower's counsel should discuss with the borrower the various conditions to closing the loan and obtaining the initial advance because some conditions may take time to satisfy. It is good practice to set up regular conference calls to review the checklist to ascertain the current status of items, *e.g.,* which ones have yet to be delivered to the lender and which have been received by the lender but are still under review and which have been approved by the lender. Without a checklist and status calls to update the checklist, it is easy to overlook a closing item and difficult to explain to the client why the loan closing is delayed because a condition has not been satisfied. Communication is critical to a smooth closing both between the lender and the borrower and between each party and its counsel to make sure all understand their roles in the closing process. Whether acting as borrower's or lender's counsel, it is important to allocate responsibility between the attorney and the client for who is handling each closing item. Some sophisticated and experienced borrowers may handle most, if not all, of the due diligence items with little assistance from counsel. Others, either because they are less sophisticated or because they are overly burdened with transactions and projects, will rely on their counsel to handle some or all of the due diligence items.

Conditions that frequently delay the loan closing include the following:

- Providing evidence of zoning (see §9.21);
- Obtaining third party consents to the various collateral assignments, including any governmental agencies and the borrower's architect, engineer, and contractor. It is important to provide all third parties with the draft consent documentation as early as possible in the closing process (see §9.17);
- Obtaining property reports (see §9.22); and
- Providing evidence of borrower's equity in the project (see §9.23).

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§9.21 a. Evidence of Zoning

The lender will require evidence that the property is zoned for the intended use and that all governmental approvals and permits required to construct the project have been obtained. Evidence of zoning may take the form of a zoning letter from the city in which the property is located or a zoning endorsement issued by the title company issuing the lender's title policy. If the loan agreement does not clearly identify what the lender requires to satisfy the zoning condition, borrower's counsel should determine if a zoning endorsement or zoning letter are required. With some lenders and sometimes for larger loans (*e.g.,* in excess of $15,000,000), the lender may require both a zoning letter and an endorsement.

Some cities do not issue zoning letters and others issue letters that are not comprehensive enough to satisfy the lender. A lender often has its own form of zoning letter. If one is not included with the loan application or closing checklist, borrower's counsel should determine if the lender has a form, to avoid the possibility of the lender rejecting the zoning letter because it fails to satisfy or address all of the lender's concerns. Borrower's counsel should ask the lender if it will accept a zoning endorsement instead of a letter from the city, if the city does not provide the letter or if the letter fails to meet the lender's requirements. From a cost analysis, it is often more economical to obtain a zoning letter, especially if the borrower, rather than the borrower's attorney, obtains the letter, because the title company charges for the zoning endorsement. A borrower who recently acquired the property may have a recent zoning letter that meets the lender's requirements. Occasionally, a non-California lender may ask for a zoning opinion from borrower's counsel, however, it is not the practice in California for counsel to render zoning opinions. See §8.72.

On zoning and land use issues generally, see California Land Use Practice (Cal CEB 2006).

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§9.22 b. Property Reports

The lender often orders the appraisal, environmental, seismic, soils, and other reports. Borrower's counsel should determine early in the loan process who is responsible for ordering these reports. Generally, reports are not ordered until the loan commitment is signed because of the costs associated with reports.

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§9.23 c. Evidence of Borrower's Equity

The loan agreement and construction budget will state the minimum equity that the borrower must contribute to the project at loan closing. Borrower's equity may consist of (1) a credit equal to the value of the land if the borrower already owns the property at closing, (2) development and construction costs previously incurred by the borrower, and/or (3) funds the borrower deposits at the closing with the lender from a source other than the loan proceeds that will be used, before any construction loan proceeds are advanced, to pay construction costs in accordance with the approved construction budget. Sometimes borrower's equity is a combination of these items.

PRACTICE TIP: Counsel must make sure that the lender and borrower agree on the amount of development and construction costs previously expended by the borrower that will be credited to borrower's equity. The lender will require that the borrower deliver evidence of the nature and amount of the preclosing expenditures. This evidence may include copies of paid invoices and mechanics' lien releases from the contractors and consultants performing the services or work.

If the borrower does not have sufficient cash to meet the lender's equity requirements, the borrower may bring in an equity partner or member to the borrowing entity to fund the equity requirement. Alternatively, the borrower may obtain mezzanine financing secured by a pledge of the ownership interests in the borrowing entity or in the ownership interests of the member of the borrowing entity. Typically, the construction lender does not allow the mezzanine financing to be secured by the project. For a discussion of mezzanine financing, see §1.16.

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§9.24 10. Conditions Precedent to Subsequent Advances

Paragraph 4.2 of the loan agreement (see §9.35) describes the conditions for subsequent loan advances. Subsequent advances are usually made monthly after the borrower delivers to the lender a request for a disbursement together with the supporting documentation required by the lender. The form disbursement request and the information required for the advance should be described in the loan agreement. A form disbursement request is typically attached to the loan agreement as an exhibit.

Lenders usually require the borrower to provide the following documentation before making a construction advance:

- A continuation endorsement to the lender's title policy insuring the continued priority of the lender's lien against the property;
- An architect's certificate, certifying that the cost of the work that is described in the disbursement request fairly reflects the value of the work and materials incorporated into the improvements and that this work has been satisfactorily completed in accordance with the approved plans and specification for the project; and
- A report from the lender's inspector that often confirms the information in the architect's certification.
- On completion of the foundation, the lender typically also requires a foundation endorsement and a foundation survey to ensure, among other things, that the foundation is within the boundaries of the property. See California Title Insurance Practice §§8.79-8.80 (2d ed Cal CEB 1997).

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§9.25 11. Conditions Precedent to Final Advance

The conditions precedent typically required by the lender before final disbursement of the loan proceeds are contained in paragraph 4.3 of the form loan agreement (see §9.35). These conditions include lien-free completion of construction of the project. The loan agreement should clearly state what "completion" means and whether it includes completion of all tenant improvements or issuance of a certificate of occupancy by the city or other governmental agency having jurisdiction over the property or both.

If the lender agrees to make the final disbursement for the shell improvement work without all tenant improvements being completed, then the lender may require that sufficient undisbursed loan proceeds remain to complete any unfinished tenant improvement work. These funds may simply be held by the lender and disbursed in accordance with the terms of the loan agreement or they may be disbursed in an escrow, either to the lender or a third party. If placed in an escrow, the funds will be deemed disbursed for interest purposes, and the lender will need a security interest in the funds in order to avoid running afoul of California's one-action rule. See CCP §726; see also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 4 (4th ed Cal CEB 2009). As a general rule, retainages are not paid until the final advance is made. Therefore, borrower's counsel should determine if there are any contractors who will require payment in full before the entire project is complete so that an exception can be made for them to be paid in full on completion of their work.

Another standard condition to the final disbursement is the issuance of a CLTA 123.2 zoning endorsement (including parking), and a comprehensive endorsement that insures that the project complies with all the conditions and restrictions recorded against the property. See California Title Insurance Practice §§7.97-7.98, 8.101 (2d ed Cal CEB 1997).

PRACTICE TIP: Although these endorsements are not issued until the project is completed, lender's counsel should negotiate the form of the endorsements at the same time the lender's title policy and other title endorsements are negotiated with the title company. The lender's closing instructions, which are acknowledged by the title company at the loan closing, should require as a condition to closing the loan that the title company commit to issue the 123.2 zoning and comprehensive endorsements on completion of the project. Parking is not always covered in the title company's standard form zoning endorsement; therefore, it is often necessary to specifically request that the endorsement ensure that there is sufficient parking to meet local parking requirements.

The lender will also require an "as built" survey showing the completed project. To the extent tenant improvement costs *are* involved, the lender will require tenant estoppel certificates in which (1) the tenant confirms that the lease is in full force and effect, rent is being paid, without any abatement, and that the tenant has accepted the leased premises, and (2) the tenant certifies that all the tenant improvements have been completed as required under the lease. The lender will also require certificates of occupancy for each completed leased space. On tenant estoppel certificates, see Retail Leasing: Drafting and Negotiating the Lease, chap 41 (Cal CEB 2007); Office Leasing: Drafting and Negotiating the Lease, chap 27 (Cal CEB 1996).

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§9.26 12. Delays

Most construction loan agreements limit the number of days that work can be stopped before the stoppage results in a loan default. This period is often short and may not take into account unavoidable delays beyond the reasonable control of the borrower. Paragraph 5.2 of the loan agreement (see §9.36) contains a *force majeure* or unavoidable delay clause that allows an additional 90 days for delays that are beyond the reasonable control of the borrower. If the loan agreement does not have an unavoidable delay clause, borrower's counsel should seek to negotiate one. Although the lender typically will allow an unavoidable delay clause, it will usually also limit the maximum number of days that construction can be delayed due to the unavoidable delay. A well-drafted lender's clause also requires the borrower to provide the lender with written notice of the delay within 10 days of its occurrence, and states that the delay will not extend the completion or maturity dates and will not suspend the borrower's other obligations under the loan documents, including the obligation to pay interest on the loan.

PRACTICE TIP: Depending on how tight the construction schedule is, the lender might allow the completion date to be extended for a period of time because of an unavoidable delay unless to do so creates too great of a risk that the project cannot be leased up between the extended completion date and the maturity date of the loan.

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§9.27 13. Changes to Approved Plans and Construction Budget

The construction loan agreement may not afford the borrower any right to amend the plans or the construction budget after the lender has approved them without first obtaining the lender's written approval. Borrower's counsel should seek to require the lender to be reasonable in its approval of changes to the plans and the construction budget. Because the borrower has an incentive to complete construction in a timely fashion, borrower's counsel should also attempt to negotiate that the lender's approval of change orders will not be unreasonably delayed. Some lenders will agree that if the lender fails to approve a proposed change order within a specified time after receipt of a borrower's request, then the lender will be deemed to have approved the change order. The lender may require that the request include within it a boldface warning of the consequences of the lender's failure to respond.

Many lenders will allow some limited number of change orders based on a maximum dollar amount (per change order and in the aggregate for the entire project) to be processed without first obtaining the lender's approval. The lender typically will not allow change orders unless the borrower shows that the change order will not increase the budget or, if it does, that either the change order will result in other cost savings in the budget to offset the increase or that the borrower will pay any increased costs necessary to keep the loan in balance (for form, see paragraph 5.2 in §9.36).

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§9.28 14. Disbursement Limitations Relating to Percentage of Work Completed and Retainages

Paragraph 6.1 of the loan agreement (see §9.38) describes the disbursement procedures for making loan advances and provides for the payment of costs for work performed, plus the cost of uninstalled materials stored in a manner acceptable to lender, less a specified retainage. A 10 percent retainage is typical in construction loan agreements. Counsel should confirm that the retainage stated in the loan agreement is consistent with the retainage required in the construction contract and in the applicable subcontracts.

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§9.29 15. Reallocating Costs Between Line Items in Approved Budget and Use of Contingency Funds

The approved budget (see Exhibit C, §9.44) sets forth on a line item basis all costs to be incurred in connection with the development of the project and all costs for which loan proceeds are to be disbursed. The lender may agree that if there are cost savings in a line item (other than the interest reserve category), those cost savings can be moved to another line item at the request of the borrower.

PRACTICE TIP: Borrower's counsel should try to negotiate a definition of "cost savings" that includes both (1) actual cost savings that can be identified because all of the work in the line item has been completed and (2) cost savings that the borrower can demonstrate to the reasonable satisfaction of the lender will exist on completion of the work.

The budget usually contains a contingency amount that reflects estimated cost overruns not included in the budget. The loan agreement should, but does not always, contain the mechanism for accessing these funds. Disbursements from contingency are usually in the discretion of the lender and are often tied to the percentage of completion of the project in order to avoid early depletion of the contingency fund. If the lender does not allow use of the fund for cost overruns, then the borrower will be required to use its own funds to keep the loan in balance.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.30 16. Construction-Related Events of Default

§9.30 16. Construction-Related Events of Default

Paragraph 7.1 of the loan agreement (see §9.39) sets forth the events of default, many of which are similar to those found in permanent loan documents. For a general discussion on default provisions, see chap 4. The construction loan agreement also contains a number of events of default that address specific concerns of the construction lender. Other than the obligation to deposit funds to keep the loan "in balance," most of these defaults relate to nonmonetary obligations of the borrower. Rather than setting out specific events of default, the construction lender could rely on the catchall default provision in paragraph 7.1(b), which makes the failure to comply with any nonmonetary covenant or obligation a default. However, the failure to comply with nonmonetary covenants is frequently accompanied by the right to receive notice of default and an opportunity to cure, typically ranging anywhere from 30 to 120 days, before the lender is entitled to enforce its rights and remedies under the loan documents. The lender will want the occurrence of certain events to immediately trigger an event of default with no further notice and with no, or very short, cure rights afforded to the borrower.

PRACTICE TIP: Borrower's counsel must review the events that will trigger an event of default and negotiate for some form of notice for all nonmonetary defaults and a reasonable cure period to the extent the default is capable of being cured.

Examples of construction-related events of default include the following:

- **Obligation to keep the loan in balance.** The borrower's failure to deposit funds with the lender as necessary to keep the loan "in balance" is usually an event of default. Because the notice and cure rights are already built into the loan provision obligating the borrower to deposit funds (see paragraph 6.2 of the loan agreement in §9.38), no further notice and cure rights are given in the default section. The cure period for failing to keep the loan in balance is usually relatively short, often between five and ten business days. Because further loan advances are suspended until the borrower brings the loan "in balance," the lender typically is unwilling to negotiate an additional or longer cure period. See paragraph 7.1(e) of the loan agreement (§9.39).
- **Defective work.** The sample loan agreement provides that defective work and materials and work that materially deviate from the plans that is not corrected within ten days each constitute an event of default. Borrower's counsel should determine whether the time given to correct defective work is sufficient. The lender may be willing to increase the time to correct defective work if it does not result in the delay or stoppage of construction, and with the understanding that the lender will not be obligated to make further construction advances relating to the defective work. Sometimes, the loan agreement may require that all work stop until the defective work is corrected. Borrower's counsel should attempt to negotiate the right to continue work that is not related to the defective work, provided that to do so would not otherwise impair the project. See paragraph 7.1(f) of the loan agreement (§9.39).
- **Encroachments.** Improvements that encroach over property boundaries, setback lines, or easements result in an immediate event of default. The borrower typically must provide the lender with a foundation survey on completion of the foundation so that the lender can confirm early in the construction process that there are no encroachments. See paragraph 7.1(g) of the loan agreement (§9.39).
- **Construction delays.** Paragraph 7.1(h) of the loan agreement (see §9.39) provides that (i) a delay in construction beyond a specified number of days; (ii) the failure to diligently proceed with construction in accordance with the construction schedule; or (iii) the failure to complete construction by the completion date are each an event of default. Many construction lenders will afford the borrower additional time for unavoidable delays provided the delay does not extend the completion or maturity date. See §9.26 on unavoidable delays.
- **Bonded stop notices.** An event of default occurs if the lender is served with a bonded stop notice. On stop notices, see California Mechanics' Liens and Related Construction Remedies (3d ed Cal CEB 1998). For form provision, see paragraph 7.1(i) of the loan agreement (§9.39).
- **Improper use of loan proceeds.** The expenditure of loan proceeds for items not listed on the construction

budget constitutes an immediate event of default. See paragraph 7.1(n) of the loan agreement (§9.39).

- **Commence and completion defaults.** Both the borrower's failure to commence construction within the time required and failure to complete construction by the completion date in accordance with the plans are events of default. Typically, the lender will be unwilling to give additional notice or cure periods for borrower's failure to meet the negotiated dates for commencement and completion of construction (see §9.5). Therefore, the borrower should make sure that the construction schedule contains ample time to complete each phase of construction and that the start and finish dates can be met. For form, see paragraphs 7.1 (r) and (t) of the loan agreement (§9.39).
- **Construction contract.** A default under the construction contract by the borrower or the general contractor is an event of default under the loan agreement. The borrower's counsel should attempt to negotiate that an event of default does not occur under the loan agreement until all applicable notice and cure periods have expired under the construction contract. If the lender has negotiated additional cure rights in the separate collateral assignment of the construction contract, then the lender may be willing to extend the borrower's cure period in the loan agreement. The construction lender will want to make sure it has the right to cure defaults under the construction contract before the contractor can terminate it. For form provision, see paragraph 7.1(s) of the loan agreement (§9.39). See form of collateral assignment of construction contract in §9.48.

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IV. THE COMPLETION GUARANTY

§9.30A A. Purpose of Completion Guaranty

Under a completion guaranty, one or more persons or entities guarantee lien-free completion of the improvements in accordance with the terms of the loan agreement, the final plans approved by the lender, and all governmental requirements. Because the borrowing entity is often a single-purpose entity with its only asset being the project that serves as collateral for the loan, the lender will usually require that one or more persons or entities with adequate net worth to satisfy the lender's underwriting criteria guarantee the project's completion. In addition, many construction lenders will also require a full repayment guaranty of the borrower's obligation to repay the loan and a guaranty of the borrower's environmental obligations under the loan documents, which are typically contained in a separate unsecured environmental indemnity agreement executed by the borrower.

Some construction lenders no longer require execution of completion guaranties when a full repayment guaranty is provided by the same guarantors on the theory that the lender is protected by the full repayment guaranty. Many construction lenders still require both a repayment and completion guaranty.

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§9.30B B. Basic Form

The form completion guaranty in §9.49 contains standard provisions typically required by construction lenders. Sections 9.30C-9.30L explain the purpose of selected provisions from the lender's prospective and suggest which provisions tend to be negotiable with the lender.

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C. Drafting and Negotiating Consideration for Completion Guaranty

§9.30C 1. Confirm Terms Conform to Loan Commitment

As with the loan agreement and other ancillary loan documents, lender's counsel is responsible for drafting the completion guaranty. Lender's counsel when drafting and borrower's counsel when reviewing should confirm that the completion guaranty accurately incorporates the relevant terms set forth in the loan application or commitment. In order to effectively represent the guarantor's interests, guarantor's counsel, if different from borrower's counsel, will need to review the loan agreement and any other loan document referred to in the completion guaranty because the covenants and obligations contained in these other loan documents will have an impact on the guarantor's obligations under the completion guaranty.

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§9.30D 2. Recitals

The recitals identify the loan documents evidencing the loan that is the subject of the completion guaranty and state that the loan directly benefits the guarantor. Recital C of the form in §9.49 states that the loan directly benefits the guarantor. In most loan transactions, the guarantor has some direct or indirect ownership interest in the borrower (such as a member, partner, or shareholder) or it is a subsidiary or affiliate of the borrower or of a principal of the borrower. The purpose of this recital is to provide additional evidence that the completion guaranty is supported by consideration due to the financial benefit that the guarantor will derive from the loan vis-à-vis the guarantor's direct or indirect ownership interest in the borrower. For a discussion on consideration for guarantees, see chap 6.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.30E 3. Guaranteed Obligations

§9.30E 3. Guaranteed Obligations

Section 1 of the form completion guaranty in §9.49 defines the "Guarantor's Obligations." Each lender will define the scope of the guarantor's obligations a little differently, but, at a minimum, the lender will require the guarantor to guarantee lien-free completion of the improvements in accordance with budget, time limits, and plans and specifications set forth in the loan agreement. Borrower's counsel should carefully review the guaranteed obligations with the guarantor to make sure the terms conform with the guarantor's understanding of the business deal. The guaranty may provide that the guarantor guarantees completion of the improvements (as that term is defined in the loan agreement). However, often the guarantor does not agree to guaranty completion of all of the improvements that the borrower is constructing. For example, the guaranty may be limited to completion of the improvements through shell completion.

PRACTICE TIP: Guarantor's counsel should confirm that the guarantor understands the scope of the work covered by the completion guaranty and, specifically, whether the scope of the work guaranteed includes completion of tenant improvements, the cost of which may be unknown (especially if the project is not fully leased) and more significantly may not be a cost that is included in the construction budget.

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§9.30F 4. Triggering Events

Section 2 of the form in §9.49 describes the events that trigger the guarantor's obligations under the completion guaranty. From the borrower's prospective, the guarantor's obligations under the completion guaranty should not be triggered until the borrower has failed to comply with its construction obligations under the loan agreement and that failure constitutes an actual event of default under the loan agreement with all cure periods having expired. The lender may argue that it wants the right to require the guarantor to step in and complete construction as soon as a construction default occurs whether or not the borrower has been given the opportunity to cure the default.

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§9.30G 5. Completion of Improvements by Guarantor

Section 3 of the form completion guaranty in §9.49 provides that, on the occurrence of a triggering event, the guarantor must diligently and timely complete the improvements in accordance with the loan agreement, perform all of the borrower's obligations under the loan agreement and other loan documents, and pay all impermissible liens. As discussed in §9.30E, the scope of the work should be carefully defined.

PRACTICE TIP: Guarantor's counsel should make sure that the guarantor is not inadvertently agreeing to perform borrower's obligations that far exceed completion of the improvements by agreeing to language such as "perform all other obligations under the loan agreement and other loan documents." Although guarantor's counsel should seek to limit this to construction-related obligations, the lender may reject this limitation because it wants to avoid a potential future dispute over which obligations in the loan agreement are construction-related.

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§9.30H 6. Disbursement of Loan Proceeds to Guarantor

Some lenders will allow the borrower to use the undisbursed loan proceeds to complete the improvements under certain circumstances that vary depending on the lender. Section 4 of the form completion guaranty in §9.49 contains fairly strict lender-oriented conditions. The condition in section 4.1 of the form that requires the guarantor to satisfy each of the disbursement conditions set forth in the loan agreement is not usually negotiable with the lender. However, a lender may be willing to waive a disbursement condition if it is impossible for the guarantor to perform or if the condition is not related to the project's construction. The condition in section 4.2 of the form requires the guarantor to cure all of the borrower's defaults under the loan documents.

PRACTICE TIP: Guarantor's counsel should seek to limit the obligation to cure only those defaults that are construction-related and only those that the guarantor is capable of curing. Wanting to avoid a future dispute, the lender may only agree to carve out specific defaults as being either incapable of cure or so unrelated to construction of the project that it is unfair to require the guarantor to cure.

If the completion guaranty is silent on the issue, guarantor's counsel should attempt to negotiate the right to use the undisbursed loan proceeds on the rationale that the guarantor is guaranteeing only cost overruns, not repayment of the entire loan. As such, the guarantor should not be required to use its own funds to pay for the cost of completing construction except to the extent the costs exceed the undisbursed loan proceeds that are allocated to construction costs.

Some lenders will only give the guarantor access to loan proceeds earmarked for hard construction costs and not interest reserve, soft costs, or other carrying costs.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.30I 7. Lender's Right to Complete Construction of Improvements

§9.30I 7. Lender's Right to Complete Construction of Improvements

Section 5 of the form completion guaranty in §9.49 gives the lender the option, on the occurrence of a triggering event, to complete the improvements and recover from the guarantor the cost of the work or to require the guarantor to complete the improvements at the guarantor's cost. The form also gives the lender the right to change the plans and specifications and recover all costs associated with constructing the project even if those costs exceed the construction budget for the project.

The lender's form of completion guaranty will typically provide that the lender is entitled to recover all costs incurred by it to complete construction of the improvements, and it will give the lender the right to change the plans and specifications if it deems the change necessary or desirable.

PRACTICE TIP: First, it is important for guarantor's counsel to make sure the guarantor is only responsible for cost overruns (or costs expended to complete the improvements that exceed the undisbursed loan proceeds). Second, guarantor's counsel should try to control the costs that the lender may recover from the guarantor if the lender elects to complete construction of the project, by requesting that the lender's right to change the plans be limited to changes that will not increase the overall construction costs set forth in the approved budget. The lender may agree to some limitations on its right to make material changes to the plans but will most likely retain the flexibility to make changes to the plans even if the related costs exceed the approved construction budget if the change is required by law, or if the lender believes the change is necessary to complete the project.

Guarantor's counsel should also negotiate that the lender will only have the right to complete construction if the guarantor is first given the opportunity to perform its obligations under the completion guaranty and fails to do so.

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§9.30J 8. Lender's Remedies

If the lender elects to complete construction of the improvements, most completion guaranties provide that the lender has the right to recover from the completion guarantor the costs incurred by the lender to complete construction of the improvements. However, under *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135 CR 802, the lender's recovery is limited to the amount by which noncompletion of the improvements has impaired its security. See §6.18. Section 6.2 of the form guaranty in §9.49 contains an acknowledgment from the borrower that it understands that the measure of damages are based on the cost to complete rather than impairment of value. If the guarantor's counsel is required to render an enforceability opinion on the completion guaranty, the opinion should be qualified by the *Glendale* case.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.30K 9. Suretyship Waivers

§9.30K 9. Suretyship Waivers

Section 11 and 12 of the form completion guaranty in §9.49 contains standard waivers of the various rights and defenses afforded guarantors and sureties and in particular contains in sections 11.1.12 and 11.1.13 the statutory safeguard waiver language contained in CC §2856.

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§9.30L 10. Termination

If the completion guaranty does not expressly state when it terminates or if it provides that it terminates on full repayment of the loan, guarantor's counsel should request that the completion guaranty terminates on completion of the improvements and satisfaction of the guarantor's obligations under the completion guaranty.

PRACTICE TIP: Because there are many ways to interpret when "completion" of construction has occurred, both counsel must take care to specifically define "completion." One way is to define "completion" as the date all of the conditions precedent to the final disbursement of loan proceeds under the loan agreement have been satisfied. See section 4.3 of the form in §9.49.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.31 V. FORM: CONSTRUCTION LOAN CLOSING CHECKLIST

§9.31 V. FORM: CONSTRUCTION LOAN CLOSING CHECKLIST

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CONSTRUCTION LOAN CLOSING CHECKLIST
[Borrower]
[Loan #]

B = Borrower L = Lender T = Title Company A = Borrower's Attorney

ITEMS REQUIRED FOR CLOSING:

Item	Description	Commitment Application Paragraph	Party Responsible for Delivery or Preparation	Status/ Comments
1.	Loan Documents		L	See Exhibit A for list
2.	Evidence Equity Requirement Met		B	
3.	Project Budget		B	
4.	Borrower's Organizational Documents:		B	
5.	Title Insurance:			
	Commitment		T	
	Recorded Documents		T	
6.	Evidence of Utilities Availability (will serve letters)		B	
7.	ALTA Survey/plat of survey (copies to Lender and title)		B	
8.	Evidence of separate assessment (most recent tax bill)		B	
9.	Soils/Geotechnical Report		B	
10.	Plans and Specifications		B	
11.	Construction Consultant Report		L	
12.	Environmental Report		L	
13.	Contracts			
	Construction		B	
	Subcontracts		B	
	Ancillary		B	
	Design Professional		B	
	Engineer		B	
14.	Construction Schedule		B	
15.	MAI appraisal		B	

16.	Insurance	B
17.	Evidence of On-Site sign	B
18.	Evidence Project complies with zoning	B
19.	Financial Statements	
	Borrower	B
	Guarantor(s)	B
	Contractor	B
20.	Permits and licenses to construction project	B
21.	Background and credit reports	L

EXHIBIT A
LOAN DOCUMENTS

Item	Description	Commitment Application Paragraph	Party Responsible for Delivery or Preparation	Status/ Comments
1.	Construction Loan Agreement			
2.	Secured Promissory Note			
3.	Construction Deed of Trust			
4.	Assignment of Leases and Rents			
5.	Guaranty of Payment and Performance			
6.	Guaranty (of Carve-Outs)			
7.	Collateral Assignment of Construction Contract and Permits and Contractor's Agreement and Consent to Assignment (executed by Borrower and Contractor)			
8.	Collateral Assignment of Design Professional's Contract Plans and Specifications and Tests and Design Professional's Agreement and Consent to Assignment (executed by Borrower and Architect)			
9.	Collateral Assignment of Engineer's Contract Plans and Specifications and Tests and Engineer's Agreement and Consent to Assignment (executed by Borrower and Engineer)			
10.	Environmental Indemnity Agreement			
11.	UCCs			

Comment: See §9.20 for a discussion of the use of the checklist. The checklist should be updated regularly to provide the current status of each condition.

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VI. FORM: CONSTRUCTION LOAN AGREEMENT

A. Form: Body of Agreement

§9.32 1. Form: Introduction and Recitals

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9.32-1 Introduction

THIS CONSTRUCTION LOAN AGREEMENT (Agreement) dated as of _ _[*date*]_ _, is entered into by and between _ _[*name*]_ _, a California limited liability company (Borrower), and _ _[*name*]_ _, a California corporation (Lender).

9.32-2 Recitals

RECITALS

This Agreement is entered into on the basis of the following facts and circumstances:

A. Borrower now owns, or will acquire, with a portion of the proceeds of this construction loan, the real property (Land) described in Exhibit A.

B. Borrower proposes to construct or to have constructed on the Land certain improvements (Improvements) in accordance with plans and specifications more particularly described in Exhibit B (Plans), which have been approved or are subject to approval by Lender. The Land and the Improvements are sometimes collectively referred to as the Property in this Agreement.

C. Borrower has applied to Lender for a loan to finance the acquisition and development of the Property and construction of the Improvements, and Lender has agreed to lend to Borrower a sum not to exceed _ _[*dollar amount*]_ _ (Loan) for payment of the individual costs of constructing the Improvements as itemized on the Approved Budget attached to this Agreement as Exhibit C and as further described in paragraph _ _[*e.g., 6.1(d)*]_ _ of this Agreement (Approved Budget). The Loan shall be evidenced by this Agreement and by the Note (as defined in Exhibit _ _[*e.g., D*]_ _) and secured by the Deed of Trust (as defined in Exhibit _ _[*e.g., D*]_ _) covering the Property and by the security instruments and additional documents as Lender may require and as described in this Agreement.

D. As further consideration for Lender making the Loan, _ _[*name*]_ _ and _ _[*name*]_ _ (collectively, Guarantor) have agreed to jointly and severally execute concurrently with this Agreement Lender's forms of unconditional Repayment Guaranty and Completion Guaranty (collectively, Guaranties) as more particularly provided in paragraph _ _[*e.g., 1.8*]_ _.

E. Lender is willing to make the Loan to Borrower for the purposes set forth and on the terms and conditions set forth in this Agreement.

NOW, THEREFORE, in consideration of these recitals and the covenants, conditions, representations, and warranties contained in this Agreement, the parties agree as follows:

Comment: The recitals briefly describe the proposed construction project and contain the legal description of the real property, which is attached as an exhibit.

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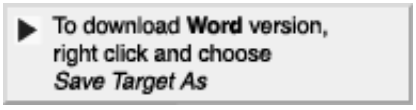
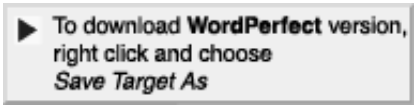
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.33 2. Form: Loan Terms

§9.33 2. Form: Loan Terms





9.33-1 Loan terms

ARTICLE I

1.1 *Amount and Purpose*. In reliance on Borrower's representations and warranties, and subject to the terms and conditions in this Agreement and in the Loan Documents (described in paragraph _ _[*e.g., 1.7*]_ _), Lender agrees to make the Loan in the amount of _ _[*dollar amount*]_ _ to Borrower on the terms and conditions set forth in the Note and other Loan Documents.

1.2 *Payment*. Borrower shall repay the Loan in accordance with the provisions of the Note and this Agreement. Except as otherwise provided, all payments shall be applied first to interest and then to principal. The principal balance outstanding under the Note shall be due and payable in full on _ _[*date*]_ _ (Maturity Date).

1.3 *Interim Financing Only*. The Loan is to provide interim construction financing only, and the Note is to be paid off in full on or before the Maturity Date (subject to the prepayment provision set forth in paragraph _ _[*e.g., 1.4*]_ _) from such sources as may be necessary to pay the Loan in full.

1.4 *Prepayment*. The Note may be prepaid in full or in part in minimum amounts of _ _[*dollar amount*]_ _, at any time without penalty, on not less than _ _[*e.g., 30*]_ _ business days prior written notice to Lender. Borrower shall have no right to reborrow any such prepaid amounts.

1.5 *Interest Reserve Account and NOI Funds*.

(a) The original principal sum of the Note has been calculated on the basis of a certified cost breakdown for the Property prepared by the Borrower and submitted to the Lender and memorialized in the Approved Budget attached to this Agreement as Exhibit C. The Approved Budget sets forth the estimated cost for the completion of the Improvements and accrued interest on the disbursed principal of the Note during the term of the Loan. Such accrued interest is estimated not to exceed the sum of _ _[*dollar amount*]_ _ (Interest Reserve Account). Subject to the conditions set forth in Article _ _[*e.g., III and IV*]_ _ of this Agreement, on the first day of each month, Lender will disburse a portion of the principal of the Note sufficient to pay accrued interest then due and payable on the Note, and this amount shall reduce the balance of the Interest Reserve Account. However, to the extent Net Operating Cash Flow (as defined below) is available, Borrower shall apply all Net Operating Cash Flow towards the payment of interest due under the Note. Notwithstanding anything to the contrary above, Lender shall not be obligated to make any disbursements from the Interest Reserve Account for the payment of interest due under the Note until Borrower has so applied the Net Operating Cash Flow and has timely submitted its operating statements pursuant to paragraph _ _[*e.g., 5.10*]_ _ of this Agreement and Lender has disbursed all NOI Funds held by Lender pursuant to paragraph _ _[*e.g., 1.5(b)*]_ _. Under no circumstances shall the undisbursed principal of the Note be disbursed to pay accrued interest on the Loan on depletion of the balance of the Interest Reserve Account. Further, the depletion of the Interest Reserve Account shall not in any manner affect or impair the Borrower's obligation to continue to pay all interest accruing on the Loan. In lieu of disbursing principal of the Note to Borrower for payment of accrued interest, Lender may handle such disbursement and payment by making appropriate entries on the books and records of Lender, and a statement summarizing such entries shall be furnished to Borrower within _ _[*e.g., 15*]_ _ business days after such entry.

For purposes of this Agreement, "Net Operating Cash Flow" shall mean all of the rents and any other cash proceeds received by Borrower from or in connection with the Improvements or the Property less any necessary operating expenses incurred by Borrower and approved by Lender in connection with the maintenance of the Improvements and the Property (including reasonable reserves), third party management

fees and expenses, the payment of insurance premiums and real property taxes on the Property, the performance of its obligations under the Tenant Leases, but excluding the payment of any debt service on the Loan, and excluding the payment of any debt service on any other loan unless consented to by Lender.

(b) Any Net Operating Cash Flow derived from the Property that is in excess of that required to pay interest due under the Note shall be deposited with Lender, on a monthly basis (NOI Funds). Borrower acknowledges that the NOI Funds shall not constitute a trust account and may be commingled with other monies held by Lender. As additional security for the payment of all sums due under the Loan and performance of the obligations of Borrower under the Loan Documents, Borrower pledges, assigns, and grants to Lender a continuing perfected security interest in and to the NOI Funds, provided that so long as there is no default under the Loan Documents, Lender shall make disbursements from the NOI Funds toward payment of interest due under the Loan to the extent required to pay accrued interest after Borrower has paid to Lender all current Net Operating Cash Flow as required under paragraph _ _[*e.g., 1.5(a)*]_ _. On the occurrence of an Event of Default, Lender may apply all or any portion of the NOI Funds to the payment of accrued and unpaid interest, principal, and other sums due under the Loan in such order, proportion, and priority as Lender may determine in its sole discretion.

1.6 *Loan Fees and Exit Fees*. Concurrently with the execution of this Agreement, Borrower shall be required to pay to Lender a nonrefundable fee equal to _ _[*e.g., 1*]_ _ percent of the maximum amount of the Loan. Lender acknowledges prior receipt of _ _[*dollar amount*]_ _ to be credited to the Loan Fee. If the Loan does not close on or before the Termination Date (defined in paragraph _ _[*e.g., 1.10*]_ _), the parties recognize that Lender will incur certain administrative costs and expenses and other damages, the amount of which will be extremely difficult and impractical to determine. Therefore, it is agreed that if the Loan does not close on or before the Termination Date for any reason, Lender shall be entitled, as liquidated damages, to the payment of the Loan Fee in full and reimbursement of all expenses, charges, costs, and fees incurred or payable by Lender in connection with the Loan. In consideration of the commitment of Lender to make the proceeds of the Loan available to Borrower, Borrower will also pay to Lender a nonrefundable Exit Fee in the amount of _ _[*dollar amount/ e.g., 50 percent of the maximum amount of the Loan*]_ _ on the earlier of the payment of the Loan in full or the Maturity Date. The Loan Fee and the Exit Fee have been earned in full and are bona fide fees intended as reasonable compensation to Lender for committing to make the Loan available to Borrower at the interest rate and on the terms set forth in this Agreement and the Note and for reserving the funds to advance the Loan. If the Loan is repaid from a permanent loan from Lender on terms and conditions acceptable to Lender, in its sole and absolute discretion, then the loan fee payable to Lender in connection with the permanent loan will be reduced by the amount of the Exit Fee actually paid to Lender.

1.7 *Loan Documentation and Security*. Borrower shall execute and acknowledge, or obtain the execution and acknowledgment of, and deliver concurrently with this Agreement, the loan documents and other documents described in Exhibit D (collectively, Loan Documents). Any reference to the Loan Documents shall refer to such documents as they may be amended, renewed, or extended from time to time with the written approval of Lender. The Loan will be evidenced by the Note and by this Agreement and secured by the Deed of Trust that shall at all times be a valid first lien on the fee simple interest in the Property and any easements and appurtenances that are or may be established to allow satisfactory ingress, egress, and operation of the Improvements; the Assignment of Leases, assigning to Lender all leases and rents; and the Security Agreement, granting to Lender a first lien security interest on all construction materials, equipment, furniture, furnishings, fixtures, and other personal property now or later acquired by Borrower and located on the Property. The Loan shall be further secured by the Assignment of Construction Contract, Architect's Contract, Plans, Permits and Subcontracts, Consent of Architect, and Consent of Contractor (as defined in Exhibit _ _[*e.g., D*]_ _), dated as of the date of this Agreement, and such other documents as Lender deems necessary (but excluding the Environmental Indemnity Agreement described in paragraph _ _[*e.g., 1.9*]_ _). All of the Loan Documents shall be in form and substance satisfactory to Lender and shall include such consents from third parties as Lender deems necessary or appropriate.

1.8 *Guaranties*. Concurrently with the execution of this Agreement, Lender shall receive, and Borrower will deliver to Lender, in form and substance satisfactory to Lender, (i) a Repayment Guaranty by which Guarantor shall, jointly and severally, unconditionally guarantee timely repayment of the Loan, and (ii) a Completion Guaranty by which Guarantor shall, jointly and severally, unconditionally guarantee that all buildings, site improvements, tenant finish-work, and all other Improvements will be fully completed to Lender's satisfaction in accordance with the final Plans approved by Lender; that such Improvements will be free of all liens, including mechanics' and materialmen's liens; that funds will be made available for such completion; that completion will occur before the Maturity Date; and that the completed Improvements will comply with all

ordinances, building codes, zoning requirements, and environmental laws and regulations, all as more particularly provided in the Guaranties.

1.9 *Environmental Indemnity Agreement*. Concurrently with the execution of this Agreement, Borrower shall execute and deliver to Lender a separate Environmental Indemnity Agreement (Environmental Indemnity) in form and substance satisfactory to Lender, pursuant to which Borrower will indemnify, defend, and hold Lender harmless from and against any and all losses, damages, claims, costs, and expenses incurred by Lender as a result of the existence or alleged existence of hazardous or toxic substances on, under, or about the Property in violation of applicable laws or ordinances as provided in the Environmental Indemnity. Lender will have no rights against Borrower under the Environmental Indemnity until after a transfer of the Property by judicial foreclosure or exercise of the power of sale pursuant to the Deed of Trust or acceptance by Lender of a deed in lieu of foreclosure. The obligations of the Borrower under the Environmental Indemnity shall not be secured by the Deed of Trust.

1.10 *Closing*. The "Loan Closing" will occur on or before _ _[*date*]_ _ (Termination Date). As used in this Agreement, the term "Loan Closing" shall mean the act of recording the Deed of Trust and the term "Closing Date" shall mean the recordation date of the Deed of Trust. Lender's obligation to make the Loan and the remainder of its obligations under this Agreement shall terminate if, on or before the Termination Date, Borrower does not satisfy the conditions set forth in Article _ _[*e.g., III*]_ _ of this Agreement.

Comment: Valid liquidated damages provisions (see paragraph 1.6 of the form) must meet the statutory requirements of CC §1671, or the lender must be able to prove actual damages at least equal to the amount stated in the provision. The burden is on the borrower to invalidate a liquidated damages provision. See CC §1671.

Although CCP §736 allows the lender to recover certain cleanup costs specified in the statute, whether or not the environmental indemnity is secured by the deed of trust (see paragraph 1.9 of the form), many lenders continue to provide that the environmental obligations are unsecured. One reason for this decision is that the costs recoverable under this statute are limited to those cleanup costs identified in the code. With an unsecured indemnity the lender may be able to recover additional costs not recoverable under §736.

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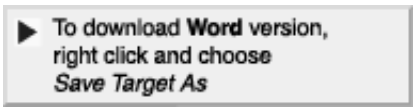
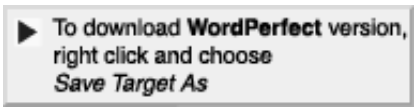
§9.34 3. Form: Borrower's Representations and Warranties





9.34-1 Borrower's representations and warranties

ARTICLE II

To induce Lender to make the Loan, Borrower represents and warrants as follows, which representations and warranties shall be true and correct as of the execution of this Agreement and shall survive the execution and delivery of the Loan Documents and the Environmental Indemnity:

2.1 *Organization of Borrower and Authority to Enter Into Agreement*. Borrower is a limited liability company, duly formed and validly existing under the laws of the State of California. Borrower has the right and power to purchase, occupy, and develop the Property. Borrower has full power and authority to enter into this Agreement, the other Loan Documents, and the Environmental Indemnity; to borrow money as contemplated in this Agreement; and to execute and carry out the provisions of the Loan Documents and the Environmental Indemnity. The execution, delivery, and performance of this Agreement, the Loan Documents, and the Environmental Indemnity have been duly authorized by all of the members of Borrower, and no other action of Borrower is required for the execution, delivery, and performance of this Agreement, the other Loan Documents, or the Environmental Indemnity. This Agreement, all other Loan Documents, and the Environmental Indemnity, which have been executed and delivered pursuant to this Agreement, constitute, or if not yet executed or delivered, will when so executed and delivered constitute, valid and binding obligations of Borrower, each enforceable in accordance with its terms, subject to bankruptcy and insolvency laws.

2.2 *Financial Statements*. All financial statements and all financial data previously delivered to Lender in connection with the Loan or the application for the Loan by or on behalf of Borrower, its general partners, members, or controlling shareholders and any Guarantors are true and correct in all material respects, have been prepared in accordance with generally accepted accounting principles consistently applied, and fairly represent the respective financial conditions of the parties who are the subjects of the financial statements and financial data as of their respective dates and for the periods covered by them, and no material adverse change has occurred in the financial conditions presented in the financial statements or financial data since their respective dates.

2.3 *No Litigation or Changes in Laws*. There are no actions, suits or proceedings, or any changes to any law, ordinance, or regulation pending, or to the actual knowledge of Borrower threatened against or affecting Borrower, its members, the Property, or any Guarantors in any court at law or in equity, or before or by any governmental or municipal authority that might adversely affect the ability of Borrower or any Guarantor to perform its obligations under this Agreement, under the Environmental Indemnity, or under any of the Loan Documents to which Borrower or any Guarantor is a party, or which might adversely affect the priority of the lien of the Deed of Trust on the Property, the construction of the Improvements in accordance with the Plans and applicable laws, or the use, occupancy, or operation of the Property or any part of the Property.

2.4 *Covenants, Zoning, and Codes*. Borrower has complied and will continue to comply with all applicable environmental statutes and regulations to be complied with in connection with the construction of the Improvements. All permits, consents, approvals, or authorizations by, or registrations, declarations, withholding of objections, or filings with, any governmental body necessary in connection with the valid execution, delivery, and performance of the Loan Documents and the Environmental Indemnity, and any and all other documents executed in connection with any of the Loan Documents, or presently necessary for the construction of the Improvements, have been obtained, are valid, adequate, and in full force and effect, or will be obtained before the commencement of the construction of any part of the Improvements. Construction of the Improvements and the intended use, occupancy, and operation of the Improvements will in all respects conform to and comply with all covenants, conditions, restrictions, and governmental regulations except that to the extent any governmental agency with jurisdiction over the Property gives Borrower a specified period of

time in writing to comply with any governmental regulations (Governmental Extension) beyond the cure period given Borrower under the Deed of Trust, then such cure period shall be extended through the Governmental Extension provided that (i) Borrower shall have provided Lender with a copy of the written notice from the governmental agency evidencing the Governmental Extension; (ii) Borrower shall at all times use its best diligent efforts to comply with all Governmental Regulations; and (iii) nothing contained in this Agreement shall be deemed or construed to extend the Completion Date or the Maturity Date.

2.5 *Access to the Property*. All roads, streets, traffic turn lanes, and accessways necessary for the full utilization of the Improvements for their intended purposes have either been completed or the necessary rights-of-way for them have either been acquired by the appropriate governmental authority or have been dedicated to public use and accepted by the governmental authority. All necessary steps have been taken by Borrower and the governmental authority to assure the complete construction and installation of these roads, streets, traffic turn lanes, and accessways by the time needed for construction, occupancy, and operation of the Improvements.

2.6 *Utilities*. All utility services and facilities necessary for the construction of the Improvements and the operation of them for their intended purposes are either available at the boundaries of the Property, or, if not, all necessary steps have been taken by Borrower and the local authority or public utility company that provides such services to assure the complete installation and availability of the utility services and facilities when needed for construction, occupancy, and operation of the Improvements.

2.7 *Approval of Plans and Budgets*. The Plans are a true and accurate reflection of the Improvements that Borrower intends to and shall construct. The Plans are satisfactory to Borrower and have been approved by Borrower, and have also been approved as required by all governmental bodies or agencies having jurisdiction and by the beneficiary of any restrictive covenant affecting the Property. After diligent investigation of all relevant conditions and due consultation with such parties as Borrower deems appropriate, Borrower represents that the Approved Budget attached as Exhibit C reflects Borrower's best true, accurate, and complete estimate of the costs shown in the Approved Budget and of the costs estimated to be necessary to construct the Improvements in accordance with the Plans.

2.8 *Compliance With Documents*. As of the date of this Agreement and for as long as the Loan Documents and the Environmental Indemnity remain in effect, Borrower is and will remain in full compliance with all of the terms and conditions of the Loan Documents and the Environmental Indemnity, respectively. Further, no event of default has or shall have occurred and be continuing which, with the lapse of time or the giving of notice, or both, would constitute such an event of default under the Loan Documents or the Environmental Indemnity.

2.9 *Marketable Title*. Borrower has, or on acquisition of the Property will have, good and marketable title to the Property, subject only to the exceptions, if any, specifically consented to by Lender.

2.10 *Leases*. There are currently no leases or other rental agreements affecting the use or occupancy of the Property. All future leases of the Property shall be subject to the terms and conditions set forth in the Assignment of Leases and Rents executed by Borrower in favor of Lender as of the date of this Agreement. On Lender's request, Borrower will obtain from the tenants of the Property estoppel certificates and/or subordination nondisturbance and attornment agreements in form and content acceptable to Lender.

2.11 *Taxes*. Borrower has filed all federal, state, county, and municipal tax returns required to have been filed by Borrower, and has paid all taxes that have become due pursuant to such returns or to any notice of assessment received by Borrower, and Borrower has no knowledge of any basis for additional assessment with respect to such taxes.

2.12 *Compliance With Agreements*. The execution, delivery, and performance of this Agreement, the other Loan Documents, and the Environmental Indemnity have not and will not constitute a breach or default under any other agreements, law, or court order under which Borrower, its members, or any Guarantor is a party or may be bound or affected or which may affect the Property or the construction, use, occupancy, or operation of all or any part of the Property subject to the cure rights afforded Borrower under paragraph _ _[*e.g., 2.4*]_ _.

2.13 *Incorporation of Representations and Warranties*. The request by the Borrower for any advance of Loan proceeds under this Agreement shall constitute a certification by the Borrower that the representations and warranties in this Agreement are true and correct as of the date of such request, except with respect to financial statements to the extent that such statements have been prepared with respect to an earlier date.

2.14 *Survival of Representations and Warranties*. All of the representations and warranties contained in this Article _ _[*e.g., II*]_ _ shall be true and correct through and until the Closing Date, and shall continue to be true and correct at all times during the term of the Loan.

2.15 *Continuing Accuracy*. During the entire period of the term of the Loan, Borrower and Guarantor, if any, shall promptly notify Lender of any event that would render any of the representations and warranties in this Agreement untrue or misleading.

Comment: Although paragraph 2.4 provides that all permits and approvals for the construction of the project have been obtained and are in full force and effect, often the borrower will not have actually obtained all of the building permits at the time the loan closes. If that is the case, the borrower will need to advise the lender of the status of governmental approvals and the estimated timing for obtaining permits. The lender will not want to defer the issuance of any permit until after closing the loan unless it is convinced that there is good reason for the delay and that issuance of the permit is administrative in nature and conditioned only on the payment of permit fees.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.35 4. Form: Conditions Precedent to Loan Closing

§9.35 4. Form: Conditions Precedent to Loan Closing

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9.35-1 Conditions precedent to loan closing

ARTICLE III

Lender's obligation to make the Loan and perform its duties under this Agreement shall be subject to the full and complete satisfaction of the following conditions precedent:

3.1 *Documents*. Lender shall have received and approved the following:

(a) Fully executed copies of each of the Loan Documents described in Exhibit D and the Environmental Indemnity, which documents shall have been duly authorized, executed (and, where appropriate, acknowledged), and delivered by the parties to the document, and any and all other documents as Lender may deem reasonably necessary with respect to the Loan.

(b) A complete set of the final Plans that have been approved by all governmental authorities having jurisdiction for the Plans.

(c) An executed guaranteed maximum price construction contract (Construction Contract) not to exceed _ _[*dollar amount*]_ _ between Borrower and _ _[*name*]_ _, a _ _[*type of entity*]_ _, (General Contractor) for construction of the Improvements.

(d) An executed architectural contract (Design Professional's Contract) between the project's design professional (Design Professional) and the Borrower for the design of the Plans.

(e) Certified copies of subcontracts in excess of _ _[*dollar amount, e.g., $100,000*]_ _, if available, and firm bids, if not available, from all material suppliers and subcontractors who will be providing materials or labor for construction of the Improvements.

(f) If required by Lender, written consents from each subcontractor to the assignment of General Contractor's interest in the subcontracts to Lender on Borrower's default under this Agreement and subcontractor's receipt of written notice from Lender that the assignment is effective.

(g) An executed engineering agreement (Engineering Agreement) between Borrower and the project's engineer (Engineer).

3.2 *Evidence of Authority*. Lender shall have received evidence satisfactory to it that Borrower and the persons signing on behalf of Borrower have the capacity and authority to execute and deliver the Loan Documents and Environmental Indemnity on behalf of Borrower and the Guarantor. Such documentation shall include, without limitation, a copy of the operating agreement, certified as true, complete, and in full force and effect by the managing member or all members, a copy of the certificate of formation, a certificate of status, and a limited liability company certificate authorizing the company to enter into the Loan and the managing member to execute the Loan Documents and Environmental Indemnity.

3.3 *Taxes*. All taxes, fees, and other charges in connection with the execution, delivery, and recording of the Loan Documents and Environmental Indemnity shall have been paid, and all delinquent taxes, assessments, or other governmental charges or liens affecting the Property, if any, shall have been paid.

3.4 *Insurance*. Borrower is required to maintain and deposit with Lender original insurance policies issued by insurance companies acceptable to Lender and written in form and content acceptable to Lender, providing the following minimum insurance coverages:

(a) All-risk course-of-construction insurance with Lender's Loss Payable Endorsement (438BFU) naming Lender attached, on a Builder's Risk Completed Value nonreporting form of policy (provided that in no event may the amount of coverage to be maintained by Borrower be less than the amount of coverage necessary to eliminate any risk of co-insurance loss).

(b) Comprehensive public liability insurance in amounts reasonably required by Lender from time to time, and in no event less than _ _[*dollar amount*]_ _ combined single limit liability insurance, naming Lender as an additional insured.

(c) Workers' compensation insurance for the contractor constructing the proposed Improvements.

(d) If the Property is located within an area designated as within the 100-year floodplain under the National Flood Insurance Program, flood insurance in the maximum amount of the Loan or the maximum coverage availability, whichever is less, designating Lender as mortgagee.

(e) After completion of construction and occupancy of the proposed Improvements, loss of rents insurance equal to _ _[*e.g., 12 months*]_ _ of expenses, taxes, and debt service on the Property written with a Lender's Loss Payable Endorsement (438BFU) naming Lender attached.

Each of the foregoing policies shall contain a _ _[*e.g., 30*]_ _-day notice of cancellation clause to Lender except as Lender otherwise approves. No such insurance shall include deductible amounts to which Lender has not previously consented in writing. No less than _ _[*e.g., 30 days*]_ _ before the expiration of each policy, Borrower shall deliver to Lender evidence of renewal or replacement of such policy satisfactory to Lender.

3.5 *Title, Legal Opinion, and Other Matters*. The condition of title to the Land, the legal description of the Land, and all documents and other matters relating in any way to the Loan or to the Property must be to the satisfaction of Lender. At Borrower's expense, Borrower is to furnish Lender with an ALTA policy of title insurance (Form B-1970), together with such endorsements to this policy as Lender may require, containing no exceptions other than those Lender approves, issued in substance and in form acceptable to Lender by a company or companies acceptable to Lender. Lender may require satisfactory evidence that the Land meets all applicable requirements of the Subdivision Map Act. Lender may require a legal opinion satisfactory to Lender from Borrower's counsel confirming that all of the documents and other matters relating to the Loan are valid, enforceable, and binding in accordance with their terms and do not violate any applicable laws, including usury laws and such other and further matters as Lender in its discretion may require regarding the Borrower or the Property. Lender may further require proof that all permits, consents, and approvals required have been obtained, and any condition to such approvals must be acceptable to Lender.

3.6 *Survey*. Borrower shall have furnished to Lender a current ALTA survey of the Property acceptable to Lender and the title insurance company issuing the title insurance policy referred to in paragraph _ _[*e.g., 3.5*]_ _, and certified in a manner satisfactory to Lender by a licensed surveyor acceptable to Lender, showing the legal description, courses, and distances of the Property lines, building setback lines, rights-of-way, appurtenant and servient easements, and such other matters as Lender may require and showing no state of facts objectionable to Lender.

3.7 *Hazardous Materials Report*. Borrower shall have furnished to Lender a current report (Environmental Report) regarding the possible presence of any hazardous substances on, in, or around the Property. Such report shall be in form and substance acceptable to Lender, prepared by a registered certified engineer or geologist acceptable to Lender, and showing no state of facts objectionable to Lender.

3.8 *Inspector*. Lender has engaged _ _[*name*]_ _ (Inspector) to provide inspections and reports with respect to construction of the Improvements and control of all funds to be disbursed under this Agreement. Borrower shall pay all fees and expenses of Inspector.

3.9 *Appraisal*. Borrower shall have furnished to Lender for its approval an appraisal of the Property current within _ _[*e.g., six months*]_ _ of the date of this Agreement and prepared by an appraiser satisfactory to Lender. The appraisal must comply with the requirements of the Lender as to form and content. The appraisal shall, among other things, reflect a loan-to-value ratio not in excess of _ _[75]_ _ percent.

3.10 *Continued Accuracy of Representations and Warranties*. All of the representations and warranties of

Borrower contained in this Agreement shall remain true and correct in all respects.

Comment: Paragraph 3.5 of the form requires a 1970 ALTA policy. Institutional lenders often require this form rather than the newer ALTA policy introduced in 1992. For a full discussion of the difference between these policies and the advantages and disadvantages of both, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997).

Paragraph 3.8 provides for the payment of the fees and costs associated with the lender's construction consultant. The borrower should make sure that the inspector's fees and costs are included in the construction budget and should attempt to negotiate a cap on them. The lender may enter into an agreement with the inspector that sets forth the fees and costs. The lender will be resistant to capping the fees and costs recoverable from the borrower.

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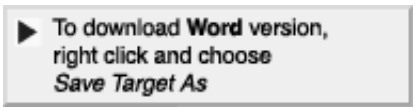
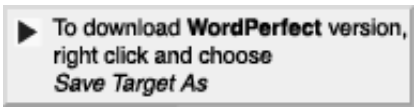
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.36 5. Form: Conditions Precedent to Loan Advances

§9.36 5. Form: Conditions Precedent to Loan Advances





9.36-1 Conditions precedent to loan advances

ARTICLE IV

4.1 *Conditions Precedent to Initial Advance*. Lender's obligation to make the initial advance of Loan funds under the terms of this Agreement shall, in addition to compliance with the terms of Article _ _[*e.g., III*]_ _, be subject to receipt of the following documents and satisfaction of the following conditions precedent:

(a) Receipt of evidence satisfactory to Lender (such as will-serve letters from appropriate governmental entities) of the availability to the Property of all public utility services and facilities when needed for construction and for use, occupancy, and operation of the Improvements.

(b) Receipt of evidence satisfactory to Lender that Borrower has complied with all covenants, conditions, restrictions, and reservations affecting the Property, that the Property is duly and validly zoned for the intended use, and that Borrower has obtained all zoning, subdivision, and environmental approvals, permits, and maps required to be obtained in order to construct the Improvements.

(c) If requested by Lender, a soils and geological report prepared by a licensed engineer acceptable to Lender, certifying in a manner satisfactory to Lender the adequacy of the subsoils and the foundation design of the Improvements.

(d) Receipt and approval by Lender of all building and other permits required for construction of the Improvements in accordance with the Plans.

(e) Receipt by Lender of the performance and the material and labor bonds, if any, described in Exhibit B in form, content, and penal sum satisfactory to Lender and naming Lender as an obligee.

(f) Receipt and approval by Lender of a site plan showing the location of any existing improvements, the proposed location of all Improvements to be constructed in accordance with the Plans, and the location of all parking areas, and listing the number of parking spaces provided by such parking areas and the number of parking spaces required by applicable zoning ordinances and certified by _ _[*name*]_ _, a _ _[*legal entity*]_ _ (Architect), to be true and correct regarding the Plans.

(g) Receipt by Lender of any deposit of money that may be required by paragraph _ _[*e.g., 6.2*]_ _, or at Lender's sole discretion, satisfactory proof that Borrower has paid the equity contribution required pursuant to paragraph _ _[*e.g., 6.2*]_ _.

(h) Any additional subcontracts in excess of _ _[*dollar amount, e.g., $100,000*]_ _ not previously submitted to Lender must be submitted to and approved by Lender.

(i) Receipt by Lender of any other documents and assurances as it may reasonably request.

(j) Evidence satisfactory to Lender that the Property is not located in an area identified as a flood-prone area as defined by the U.S. Department of Housing and Urban Development pursuant to the Flood Disaster Protection Act of 1973.

(k) No condition to subsequent advances as set forth in paragraph _ _[*e.g., 4.2(a), (b), or (c)*]_ _ shall be breached with respect to the first advance.

4.2 *Conditions Precedent to Subsequent Advances*. In addition to compliance with the conditions precedent

set forth in Article _ _[*e.g., III*]_ _ and paragraph _ _[*e.g., 4.1*]_ _, Lender's obligation to make any advance of Loan funds after the initial advance shall be subject to satisfaction of the following conditions precedent:

(a) Borrower shall be in full compliance and shall not be in default under this Agreement or under any of the Loan Documents, provided, however, that Lender may, in its discretion, elect to make advances despite the existence of a default, and any advance so made shall be deemed to have been made under this Agreement and shall be secured by the Loan Documents.

(b) Neither the Improvements, to the extent then constructed, nor all or any part of the Property shall have been materially damaged, destroyed, condemned, or threatened with condemnation.

(c) No order or notice shall have been made by, or received from, any governmental agency having jurisdiction stating that the work of construction is or will be in violation of any law, ordinance, code, or regulation affecting the Property.

(d) Before each disbursement, Lender may, if it determines that such endorsement is necessary to protect its first lien, receive a current CLTA Form Endorsement No. 122 (Continuation Endorsement) and, to the extent that such disbursement relates to completion of the foundation, a current CTLA Form Endorsement No. 102.5 (Foundation Endorsement) to such title policy, and such other endorsements to its title insurance policy as Lender may, in its discretion, determine are necessary. All such endorsements must be satisfactory to Lender.

(e) Any additional subcontracts not previously approved by Lender must be submitted to and approved by Lender.

(f) Receipt by Lender of a report from each the Inspector and the Architect certifying the amount of such disbursement fairly reflects the value of the work and materials incorporated into the Improvements and that the work being paid for has been satisfactorily completed in accordance with the Plans.

(g) Receipt and approval by Lender of a current Environmental Report if requested by Lender.

(h) On completion of the foundation, receipt and approval of a foundation survey in form and content acceptable to Lender.

(i) Receipt and approval by Lender of a fully executed Request for Subsequent Advance.

[*If appropriate, add*]

(j) For any advance made _ _[*e.g., one year*]_ _ from the date of this Agreement, Lender shall have approved the Standard Lease Form as required in paragraph _ _[*e.g., 5.16*]_ _ and Borrower shall have delivered to Lender fully executed copies of the Management Documents as required under paragraph _ _[*e.g., 5.17*]_ _.

[*Continue*]

4.3 *Conditions Precedent to Final Advance*. In addition to the conditions set forth in Article _ _[*e.g., III*]_ _ and paragraphs _ _[*e.g., 4.1 and 4.2*]_ _, Lender's obligation to make the final advance of Loan funds for construction purposes shall be subject to the satisfaction of the following conditions precedent, each of which Borrower shall endeavor to furnish as promptly as is reasonably possible:

(a) Completion of construction of the Improvements in accordance with the Plans, and if required by Lender, its receipt of a Certificate of Completion from the Architect and the Inspector certifying that the Improvements have been completed substantially in accordance with the Plans.

(b) Receipt by Lender of a copy of a recorded notice of completion sufficient to effect the purpose of such notices as contemplated by the laws of the state in which the Improvements are located relative to mechanics' liens.

(c) Receipt by Lender of the final permanent certificate(s) of occupancy for the Improvements issued by the appropriate governmental authority having jurisdiction and for each space within the Property that is occupied by tenants.

(d) Receipt by Lender of such title insurance endorsements as it may require to its title insurance policy

insuring that the Improvements have been completed free of mechanics' liens, and a CLTA 123.2 zoning endorsement or, at Lender's election, an ALTA rewrite of its title insurance policy together with such endorsements to the policy as Lender may require.

(e) Receipt of an "as built" survey prepared by a licensed surveyor, locating all property lines, building setback lines, easements, and the Improvements and containing such other matters as Lender may require.

(f) There shall be no statutory liens on record for labor or material arising out of the construction of the Improvements, provided, however, that if there are any such liens Borrower shall have made arrangements satisfactory to Lender for the disposition or bonding of these liens.

(g) On completion of the Improvements, Borrower shall deliver to Lender a completion certificate containing the following: (i) the Borrower's statement of the aggregate amount of costs incurred in connection with the construction of the Improvements but not paid by the Borrower before the Completion Date (as defined in paragraph _ _[*e.g., 5.2*]_ _) and (ii) Borrower's certification that no portion of the Loan proceeds has been applied to pay or reimburse any costs or expenses other than these construction and acquisition costs, together with interest and fees incurred in connection with the Loan.

(h) All tenant improvements required by the Plans shall have been completed, or, if some remain to be completed, Lender may, at its option, make the final advance but retain sufficient Loan funds that, in Lender's sole and absolute judgment, are sufficient to complete and pay the cost of these improvements. Lender further reserves the right to request estoppel certificates from each tenant of the Property, in form and content satisfactory to Lender, certifying the tenant's acceptance and occupancy of its premises under the terms of its lease.

(i) Receipt by Lender of final reports from each of the Inspector and Architect certifying (i) that the Improvements have been completed in substantial compliance with the approved Plans and (ii) the aggregate cost of the Improvements.

Comment: Paragraphs 4.2(d) and 4.3(d) contain the lender's requirements for endorsements to the title policy. For a comprehensive discussion of lender endorsements, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997).

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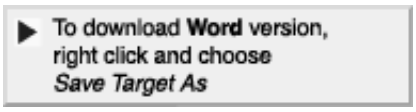
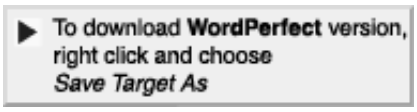
§9.37 6. Form: Construction Loan Covenants





9.37-1 Construction loan covenants

ARTICLE V

Borrower covenants and agrees as follows:

5.1 *General*. From and after the date of this Agreement and as long as any amount remains unpaid on the Note, or for so long as any commitment exists to extend credit under this Agreement, Borrower covenants and agrees that it will do the following:

(a) Promptly pay principal and interest and all other sums falling due under the Note as and when the same becomes due and payable.

(b) Promptly deposit with Lender all sums required under paragraph _ _[*e.g., 6.2*]_ _.

(c) Preserve and keep in full force and effect its existence as a limited liability company and retain title to the Property subject only to exceptions permitted by Lender.

(d) Maintain, preserve, and keep its properties and equipment in good repair, working order, and condition and from time to time make all needful and proper repairs, renewals, replacements, and additions to them so that at all times their efficiency shall be fully preserved and maintained.

(e) Pay when due and before any penalty attaches all general taxes and all special taxes, special assessments, water charges, drainage and sewer charges, and all other charges of any kind, ordinary or extraordinary, that may be levied, assessed, imposed, or charged on or against the Property or any of Borrower's properties, and on written request exhibit to Lender official receipts evidencing such payments.

(f) Obtain and maintain the insurance required in this Agreement.

(g) Pay all costs, expenses, and fees incurred by Lender arising out of or incurred in connection with any of the transactions contemplated by this Agreement and, without limiting the generality of the foregoing, pay all taxes, filing and recording expenses (including stamp taxes, if any), all title insurance charges, all escrow fees and expenses, all appraisal fees and expenses, the fees and commissions lawfully due to brokers and consultants in connection with the transactions contemplated by this Agreement, the fees and expenses of any architect, engineer, or surveyor, and reasonable attorney fees and court costs actually incurred by Lender in connection with this transaction. Borrower agrees to indemnify, defend, and save the Lender harmless from and against any and all claims, demands, losses, liabilities, obligations, penalties, fines, actions, causes of action, judgments, suits, proceedings, costs, disbursements, and expenses incurred by the Lender in connection with the transactions contemplated by this Agreement, excluding any losses or claims caused solely by the gross negligence or willful misconduct of Lender. If Borrower shall fail to pay any of the foregoing, Lender may pay the same, and amounts so expended shall, at Lender's option, constitute advances of the Loan evidenced by the Note or advances made under the Deed of Trust (which advances shall in any event be secured by the Deed of Trust and additional Loan Documents), but any such payment by Lender shall not be deemed to cure any default under this Agreement.

5.2 *Construction Start, and Completion*. Borrower shall commence construction of the Improvements no later than _ _[*e.g., 30 days*]_ _ from the date of this Agreement and then shall diligently proceed with construction of the Improvements, in a good and workmanlike manner in accordance with the Plans, and shall complete construction of the Improvements in accordance with the Plans pursuant to the schedule set forth in Exhibit _ _[*e.g., B-1*]_ _ and on or before the date set forth in Exhibit B for the completion of construction (Completion

Date). On completion of the Improvements, Borrower will immediately cause the Improvements to be inspected by each appropriate governmental body, shall correct any defects and deficiencies that may be disclosed by any such inspection, and shall cause to be duly issued all occupancy certificates and other licenses, permits, and authorizations necessary for the operation and occupancy of the Property. In any event, Borrower shall do and perform all of these acts and things and cause to be issued and executed all such occupancy certificates, licenses, and authorizations on or before the Completion Date. After commencement of the Construction of the Improvements (Construction Work), Borrower shall not permit cessation of such Construction Work for a period in excess, in the aggregate, of _ _[*e.g., 20*]_ _ calendar days for any reason. Notwithstanding the foregoing, this _ _[*e.g., 20*]_ _-calendar-day period shall be extended, but only up to an aggregate maximum of _ _[*e.g., 90*]_ _ days not to exceed the Maturity Date in any event, for any delays that are beyond the control of Borrower, including delays caused by strikes, acts of God, weather, inability to obtain labor or materials, inability to obtain governmental permits or approvals, governmental restrictions, civil commotion, fire, or similar causes (Unavoidable Delay) (but excluding financial circumstances or events that may be resolved by the payment of money), and provided Borrower has notified Lender of such delay within _ _[*e.g., 10*]_ _ days of its occurrence, and provided that no Unavoidable Delay shall (i) suspend or otherwise abate any obligation of Borrower to pay any sum of money, including principal and interest, under the Loan Documents, (ii) suspend or abate any other obligation of Borrower under the Loan Documents, or (iii) extend the Completion Date or the Maturity Date.

5.3 *Changes to Plans*. There shall be no material change of any of the Plans or working drawings, whether by change order or otherwise, without the prior written approval of Lender and, to the extent that such approvals may be required, the prior written approval of all appropriate governmental authorities and the Inspector. As a condition to its approval of any change, Lender may require verification that the change will not increase the total cost of constructing the Improvements or the time required to complete the construction of the Improvements. If the proposed change may affect the Approved Budget, Borrower shall follow the procedure described in paragraph _ _[*e.g., 6.1(e)*]_ _ in requesting Lender to approve such change.

5.4 *Permanent Commitment*. If Borrower enters into a binding loan application or commitment for permanent financing for the Property on completion of the improvements (Permanent Commitment) from a lender (Permanent Lender) after complying with paragraph _ _[*e.g., 8.1*]_ _, then Lender may require Borrower to assign the Permanent Commitment to Lender as additional security for the Loan and to obtain the Permanent Lender's consent to such assignment.

5.5 *Leases*. Borrower shall not execute any lease to any portion of the Property, or execute any amendment to or modification of any such lease, without the prior written consent of Lender except as otherwise provided in the Assignment of Leases and Rents (see Exhibit E). Borrower shall promptly notify Lender of any event of default or cancellation under any leases now or hereafter in effect.

5.6 *Personal Property Incorporation*. No materials, equipment, or fixtures shall be purchased or installed in the Improvements under any security agreement, conditional sales contract, or other agreement in which the seller reserves a security interest in, or the right to remove, or to repossess, these items or to consider them personal property after their incorporation into the work of construction without Lender's written consent. All personal property or construction material for which Lender advances Loan proceeds shall be stored on the Property and in Lender's judgment must be reasonably secure from damage and theft and fully insured at all times.

5.7 *Compliance With Laws*. All work performed in connection with the Improvements shall comply with all applicable laws, ordinances, rules, and regulations of federal, state, county, or municipal governments or agencies now in force or which may be enacted after this Agreement, and with all directions, rules, and regulations of the fire department, health department, building department, or other departments of every governmental agency now having or hereafter acquiring jurisdiction over the Property or construction of Improvements.

5.8 *Protection Against Liens*. Borrower agrees to pay and discharge all claims for labor performed and material and services furnished in connection with construction of the Improvements, to diligently record or procure the recordation of a valid Notice of Completion on completion of construction, to diligently record or procure for recordation of a notice of cessation in the event of a cessation of labor, on the work of improvement for a continuous period of _ _[*e.g., 30*]_ _ days or more, and to take all other steps necessary to forestall the assertion of claims or liens either against all or any part of the Property or the Improvements or right or interest appurtenant to the Property or the Improvements, or of claims against Lender or the Loan

funds. Nothing contained in this Agreement shall require Borrower to pay any claims for labor, materials, or services that Borrower, in good faith, disputes and that Borrower, at its own expense, is currently and diligently contesting, provided, however, that not later than _ _[*e.g., 10*]_ _ days after the notice of the filing of any claim or lien against the Property that is disputed or contested by Borrower, Borrower shall either (i) record a surety bond sufficient to release said claim or lien and promptly give notice of such recordation to the lienholder or claimant, or (ii) make other arrangements satisfactory to Lender. Lender shall not be required to extend the Maturity Date of the Loan by reason of Borrower's failure to pay such claims.

5.9 *Construction Inspections*. Lender and its representatives shall have the right at all reasonable times during regular business hours (and at any time in the event of an emergency) to enter on the Property and inspect the work of construction to determine that the same is in conformity with the Plans and all of the requirements of the Plans. If in Lender's judgment it is necessary, Lender shall have the further right, from time to time, to retain consultants, at Borrower's expense (which shall be reasonable in amount), to inspect the Construction Work and verify compliance by Borrower with the Plans and the provisions of this Agreement and the Loan Documents. Borrower understands and agrees that said inspections are for the sole purpose of protecting Lender's Loan advances and security for the Loan and are made solely for the Lender's benefit; that such inspections may be superficial and general in nature, primarily to inform Lender of the progress of construction of the Improvements; and that, in any event, Borrower shall not be entitled to rely on any such inspection(s) as constituting Lender's approval, satisfaction, or acceptance with respect to materials, workmanship, conformance to Plans, or otherwise. Borrower agrees to make its own inspections of the construction to determine that the quality of the Improvements and all other requirements of the work of construction financed by the Loan are being performed in a manner satisfactory to Borrower, and Borrower agrees to immediately notify Lender in writing should the same show any work to be unsatisfactory if the cost to correct the work is estimated to exceed _ _[*e.g., $10,000*]_ _. Without limiting the foregoing, Borrower shall permit Lender to examine and copy all books and account records and other papers relating to the Property and the construction of the Improvements. Borrower will, and will use its best efforts to cause all contractors, subcontractors, and materialmen to, cooperate with Lender to enable it to do so.

5.10 *Annual Operating Statements, Additional Financial, and Other Records*. Within _ _[*e.g., 120*]_ _ days after the close of each fiscal year of Borrower and within _ _[*e.g., 15*]_ _ days of the close of each interim monthly accounting period of Borrower, Borrower shall deliver or cause to be delivered to Lender financial statements for Borrower, and within _ _[*e.g., 90*]_ _ days after the close of each calendar year of each Guarantor, Borrower shall deliver or cause to be delivered to Lender financial statements of each Guarantor. Such financial statements shall include a balance sheet, rent roll (including the monthly rental, term, any delinquencies, and such other terms as Lender may reasonably request), statement of income and expenses and statement of cash flows that include (as appropriate) the results of the financial operation of the Property and showing the calculation of Net Operating Cash Flow for each calendar month, all in reasonable detail and prepared on a modified cash/accrual basis. Year-end statements shall be certified by an independent certified public accountant and interim monthly statements shall be certified by the Borrower. When requested by Lender, Borrower shall promptly deliver or cause to be delivered, in writing, such further information as Lender may reasonably request relating to any such financial statements.

5.11 *Notify Lender of Litigation or Compliance*. Borrower shall promptly notify Lender in writing of all litigation or possible litigation affecting Borrower, any member of Borrower, any Guarantor, or all or any part of the Property, and of all complaints or charges made by any governmental authority affecting the Property or Borrower which may delay, or require changes in, the construction of the Improvements or impair the security of Lender.

5.12 *No Secondary Financing*. At no time during the term of the Loan may the Property be encumbered by the lien of any other lender or creditor except as may be specifically approved in advance in writing by Lender, or except as may be expressly permitted in this Agreement.

5.13 *Indemnify Lender*. Borrower shall indemnify and hold the Lender and its successors and assigns harmless from all losses for any actual or alleged damage or injury of any nature arising out of or in any way connected with the Property or the construction of the Improvements or arising out of Borrower's breach of the provisions of this Agreement or any of the other Loan Documents unless such loss is caused solely by the gross negligence or willful misconduct of Lender. Lender may commence, appear in, or defend any action or proceeding purporting to affect the rights, duties, or liabilities of the parties to this Agreement, or the Property or the Improvements, and Borrower shall pay all of Lender's reasonable costs and expenses so incurred on demand. This section shall survive execution, delivery, and performance of this Agreement and the other Loan

Documents.

5.14 ***Environmental Covenants.***

(a) Borrower will not use any Hazardous Materials (as defined in paragraph _ _[*e.g., 15.4(f)*]_ _) in the construction of the Improvements except in compliance with all applicable laws regulating Hazardous Materials and in accordance with sound industry practices.

(b) Borrower shall, at its expense, comply and use commercially reasonable efforts to cause each tenant leasing space within the Property to comply with all applicable laws, regulations, codes, and ordinances relating to any Hazardous Materials or to any Environmental Activities (as defined in paragraph _ _[*e.g., 5.14(f), (g)*]_ _), including, without limitation, obtaining and filing all applicable notices, permits, licenses, and similar authorizations.

(c) Borrower agrees to submit from time to time, if requested by Lender, a report, satisfactory to Lender, certifying to the best knowledge of Borrower, after diligent inquiry and investigation, that the Property and the Improvements are not now being used nor have they been used in the past for any Environmental Activities. Lender reserves the right, in its reasonable discretion, to retain, at Borrower's reasonable expense, an independent professional consultant to review any report prepared by Borrower and to conduct its own investigation of the premises and Improvements for Hazardous Materials. Borrower grants to Lender, its agents, employees, consultants, and contractors the right to enter on the Property and Improvements and to perform such tests as are reasonably necessary to conduct such a review and/or investigation, subject to the rights of tenants leasing space within the Property under Leases approved by Lender.

(d) On the discovery by Borrower of any event or situation that would render any of the representations or warranties concerning the environmental condition of the Property contained in the Loan Documents or the Environmental Indemnity inaccurate in any respect if made at the time of such discovery, Borrower shall promptly notify Lender of this event or situation and, within _ _[*e.g., 30*]_ _ days after such discovery, submit to Lender a preliminary written environmental plan including a general description of the event or situation and the action that Borrower proposes to take. Within _ _[*e.g., 60*]_ _ days after such discovery, Borrower shall submit to Lender a final written environmental report including a detailed description of the event or situation and the action that Borrower proposes to take, including, without limitation, any proposed corrective work, the estimated cost and time of completion, the name of the contractor, a copy of the construction contract, if any, and such additional data, instruments, documents, agreements, or other materials or information as Lender may reasonably request. The plan shall be subject to Lender's written approval, which approval shall not be unreasonably withheld. Lender shall notify Borrower in writing of its approval or disapproval of the final plan within _ _[*e.g., 15*]_ _ days after receipt of the final plan by Lender. If Lender reasonably disapproves the plan, Lender's notice to Borrower of such disapproval shall include a detailed explanation of the reasons for the disapproval. Borrower shall submit to Lender a revised final written environmental plan that remedies the defects identified by Lender as reasons for Lender's disapproval of the initial final plan. If Borrower fails to submit a revised plan to Lender within this _ _[*e.g., 30*]_ _-day period, or if such revised plan is submitted to Lender and Lender disapproves this plan, such failure or disapproval shall, at Lender's option and on notice to Borrower, constitute an "Event of Default" under this Agreement, in which event Lender's obligation to make further Loan disbursements shall abate and Lender shall have all of the rights and remedies available to it under paragraph _ _[*e.g., 7.2*]_ _. If Lender does not notify Borrower of its approval or disapproval of the final plan or any revisions of the final plan within the _ _[*e.g., 15*]_ _-day period described above, Borrower shall provide written notice to Lender of Lender's failure to respond, at which time Lender shall have an additional _ _[*e.g., 45*]_ _ days after receipt of such notice from Borrower to notify Borrower of its approval or disapproval of the final plan within this additional _ _[*e.g., 45*]_ _-day period. If Lender fails to notify Borrower of its disapproval or approval of said plan within this _ _[*e.g., 45*]_ _-day period, this plan shall be deemed approved. Once any such plan is approved in writing or deemed approved by Lender, Borrower shall promptly commence all action necessary to implement such plan and to comply with any requirements and conditions reasonably imposed by Lender, and shall diligently and continuously pursue such action to completion in strict accordance with the terms of the plan. The rights of Lender with respect to the approval or disapproval of the toxic plan set forth in this Agreement and the actions of Lender in accordance with such rights are not intended to, and shall not, in and of themselves, confer on Lender a right to manage, operate, or control the Property on a continuing basis following the discovery of the event(s) or occurrence(s) described in this paragraph _ _[*e.g., 5.14(d)*]_ _.

(e) Borrower agrees to submit from time to time, if requested by Lender, a report, reasonably satisfactory to

Lender, specifying any activities involving, directly or indirectly, the use, generation, treatment, storage or disposal of any Hazardous Materials on the Property or in the Improvements. Lender reserves the right, in its sole and good faith discretion, to retain, at Borrower's reasonable expense, an independent professional consultant to review any report prepared by Borrower and/or to conduct its own investigation of the Property. Borrower hereby grants to Lender, its agent, employees, consultants and contractors the right to enter on the Property and to perform such tests as Lender deems are necessary to conduct such a review and/or investigation subject to the rights of tenants leasing space within the Property under Approved Leases. Lender shall hold in confidence any report delivered by Borrower to Lender pursuant to this paragraph _ _[*e.g., 5.14*]_ _, except for disclosure (i) to any consultant(s) Lender hires to review this report or, (ii) to any participant in the Loan, (iii) to legal counsel, accountants, and other professional advisors to Lender or any participant in the Loan, (iv) to regulatory officials having jurisdiction over Lender or any participant in the loan who may request this report, (v) as required by any federal, state, county, regional, or local authority or law, rule, regulation or ordinance, (vi) as required in connection with any legal proceeding, and (vii) to any financial institution in connection with a disposition or proposed disposition of all or part of Lender's or any participant's interests under this Agreement.

(f) "Hazardous Materials" as used in the Agreement and the other Loan Documents shall mean any hazardous or toxic materials, pollutants, effluents, contaminants, radioactive materials, flammable explosives, chemicals known to cause cancer or reproductive toxicity, emissions or wastes and any other chemical, material or substance, the handling, storage, release, transportation, or disposal of which is or becomes prohibited, limited, or regulated by any federal, state, county, regional, or local authority or which, even if not so regulated, is or becomes known to pose a hazard to the health and safety of the occupants of the Property including (i) asbestos; (ii) petroleum and petroleum by-products; (iii) urea formaldehyde foam insulation; (iv) polychlorinated biphenyls; (v) all substances now or hereafter designated as "hazardous substances," "hazardous materials," or "toxic substances" pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), 42 USC §§9601 *et seq.,* as amended by the Superfund Amendments and Reauthorization Act of 1986 (SARA), the Federal Water Pollution Control Act, 33 USC §§1251 *et seq.,* the Clean Air Act, 42 USC §§7401 *et seq.,* the Hazardous Materials Transportation Act, 49 USC §§5101 *et seq.,* or the Resource Conservation and Recovery Act of 1976 (RCRA), 42 USC §§6901 *et seq.;* (vi) all substances now or hereafter designated as "hazardous wastes" in §25117 of the California Health & Safety Code or as "hazardous substances" in §25316 of the California Health & Safety Code; (vii) all substances now or hereafter designated by the Governor of the State of California in accordance with the Safe Drinking Water and Toxic Enforcement Act of 1986 as being known to cause cancer or reproductive toxicity; (viii) all substances now or hereafter designated as "hazardous substances," "hazardous materials," or "toxic substances" under any other federal, state, or local laws or in any regulations adopted and publications promulgated pursuant to said laws.

(g) "Environmental Activities" as used in this Agreement shall mean the use, generation, transportation, treatment, storage, or disposal of any Hazardous Materials at any time located or present on, under, or about the Property.

5.15 *Further Assurances*. Borrower, will at any time, and from time to time, on Lender's request, take or cause to be taken any action and execute, acknowledge, deliver, and record any further documents, opinions, mortgages, security agreements, financing statements, or other instruments or obtain such additional insurance as Lender in its discretion deems reasonably necessary or appropriate to carry out the purposes of this Agreement and to preserve, protect, and perfect the security intended to be created and preserved in the Property or as may be required to keep any Permanent Commitment now or hereafter executed in full force and effect.

[*If appropriate, add*]

Borrower shall promptly cause the loan with the Permanent Lender that is contemplated by the Permanent Commitment (Permanent Loan) to be funded by the Permanent Lender pursuant to the Permanent Commitment on substantial completion of the Improvements, and shall cause the Permanent Lender to remit through escrow to Lender such proceeds of the Permanent Loan as may be required to pay the Loan in full. Borrower authorizes Lender to provide any and all information and data furnished by or on behalf of Borrower to the Permanent Lender as Lender deems in its best interests, and further, irrevocably authorizes Lender to act as agent and attorney-in-fact for Borrower (such agency being coupled with an interest) to do all things that Lender deems necessary to accomplish funding of the Permanent Loan.

[*Continue*]

[*If appropriate, add*]

5.16 *Standard Form of Lease*. Within _ _[*e.g., one year*]_ _ after the date of this Agreement, Lender shall have reviewed and approved (which approval will not be unreasonably withheld) the standard form of lease (Standard Lease Form) to be used by Borrower in connection with the lease of space within the Improvements as provided by the Assignment of Leases and Rents executed by Borrower in favor of Lender.

[*Continue*]

[*If appropriate, add*]

5.17 *Management Documents*. Within _ _[*e.g., one year*]_ _ following the date of this Agreement, Lender shall have received the following documents relating to the management of the Property: (i) a management agreement, in form reasonably acceptable to Lender (Management Agreement) duly executed by Borrower, as owner, and _ _[*name of management company*]_ _, or such other property manager unrelated to the Borrower with experience managing _ _[*e.g., first-class apartment buildings*]_ _ of similar size and character as the Improvements and otherwise reasonably acceptable to Lender (Property Manager); (ii) a Collateral Assignment of Management Agreement as defined in Exhibit _ _[*e.g., D*]_ _, in form reasonably acceptable to Lender, duly executed by the Property Manager and Borrower, in favor of Lender, assigning the rights of Borrower under the Management Agreement to Lender and subordinating the management fees to the Loan; and (iii) a Consent to Collateral Assignment of Management Agreement as defined in Exhibit _ _[*e.g., D*]_ _, duly executed by the Property Manager, in favor of Lender, consenting to the assignment of the Management Agreement and subordination of its fees to the Loan.

[*Continue*]

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§9.38 7. Form: Disbursement of Loan Funds

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9.38-1 Disbursement of loan funds

ARTICLE VI

6.1 *Advances of Loan Funds*. Unless Lender elects otherwise in Lender's sole discretion, all advances of the Loan shall be made in accordance with the following:

(a) At the time of the requested advance, Borrower must (i) not be in default under this Agreement or any other Loan Document; (ii) have cured any nonperformance of any event that, after notice of the event by Lender, or with the passage of time or both, could constitute a default or an Event of Default; and (iii) have met all requirements of any governmental authority pertaining to Borrower or the Property.

(b) Subject to the provisions of this Agreement, advances will be made by Lender only for payment of those items shown in the Approved Budget.

(c) Disbursements of Loan proceeds for construction items shall be made monthly within _ _[*e.g., 10*]_ _ business days after Borrower's compliance with the terms of this Agreement, in amounts equal to the total of (i) the aggregate purchase price of uninstalled materials stored on the Land in a manner acceptable to Lender, plus (ii) the aggregate cost of the portions of the work acceptably completed as approved by Lender, less (iii) retainage of _ _[*e.g., 10*]_ _ percent or such lesser amount as provided in subcontracts approved by Lender (unless retainage is waived by Lender or has otherwise been deducted), and less (iv) the aggregate amount of all prior advances under the Loan. Retained construction funds shall be disbursed on satisfaction of conditions precedent identified in paragraph _ _[*e.g., 4.3*]_ _. The monthly construction disbursements will be made to Borrower on receipt by Lender of the following:

(i) Copies of all subcontracts in excess of _ _[*e.g., $100,000*]_ _ available at the time of the Loan Closing, which Subcontracts must be satisfactory to Lender. Subsequent to the Loan Closing, Borrower will supply Lender with executed copies of all other subcontracts in excess of such amount promptly on execution. Until Borrower has done so and has obtained Lender's approval of these subcontracts, Lender will not be obligated to disburse proceeds to pay any costs incurred under them. Lender shall be deemed to have approved any subcontract and the subcontractor under the subcontract if Lender has not disapproved of such subcontract or subcontractor within _ _[*e.g., 10*]_ _ days after receiving the executed copy of the subcontract together with Borrower's request for approval. If Lender so requests, Borrower will assign Borrower's interest or cause the interest of the General Contractor in any or all of such contracts to be assigned to Lender;

(ii) A schedule of estimated monthly disbursements, updated monthly, must accompany each disbursement request;

(iii) Requisition forms approved by Lender (as may be changed by Lender from time to time), showing a complete and detailed breakdown, including, but not limited to, the total amount actually expended by Borrower and that portion of costs actually reimbursed to Borrower;

(iv) Satisfactory certification from Borrower and the General Contractor that all Loan proceeds previously received and currently requested have been or will be disbursed in a timely manner solely in payment of project costs authorized by the Approved Budget and actually incurred;

(v) Certification acceptable to Lender from Borrower, the Architect, if any, the Inspector, and the General Contractor, stating:

(A) The percentage of completion of the Improvements on a line-item basis (as such line items are identified

in the Approved Budget) with respect to each aspect of the cost of construction;

(B) The costs to complete the Improvements in accordance with the Plans approved by Lender on a line-item basis (as such line items are identified in the Approved Budget); and

(C) That all Improvements are constructed in accordance with the Plans approved by Lender.

(vi) Appropriate lien releases from all contractors, subcontractors, and materialmen who were paid with the Loan disbursement made during the prior month.

(d) The "Approved Budget" means a budget that has been submitted by Borrower and approved by Lender before Loan Closing and that identifies on a line-item basis all costs to be incurred in connection with the development of the Property and all costs for which proceeds of the Loan are to be disbursed (Project Costs). The Approved Budget is attached as Exhibit C.

(e) Before any advance of Loan proceeds for costs incurred in connection with the development or construction of the Improvements that are not within the Approved Budget, Borrower shall furnish Lender with a statement of additional expenses that covers all additional costs to be incurred in connection with the acquisition and development of the Property and the portions of these costs that are to be financed by the Loan, with the dollar cost breakdown in such detail as Lender may require, including verification of any costs specified by Lender. Lender reserves the right to withhold its consent to any proposed amendment to the Approved Budget until such time as the Borrower has deposited sufficient cash with Lender as described in paragraph _ _[*e.g., 6.2*]_ _.

6.2 *Borrower's Funds*. Any money required in excess of the Loan funds to fully pay all costs incurred in construction of the Improvements must be provided by Borrower (Borrower's Deposit) and shall be actually deposited with Lender and advanced by Lender before the advance of any Loan funds under this Agreement. The amount of Borrower's initial equity contribution, if any, is set forth in Exhibit C. Despite any provisions to the contrary contained in this Agreement, at no time shall Lender be obligated to make any advance under this Agreement if, in Lender's reasonable judgment, it appears that for any reason the remaining undisbursed Loan funds will be insufficient to complete construction of the Improvements in accordance with the Plans until Borrower deposits with Lender such additional funds as, in Lender's judgment, will be sufficient to complete and fully pay the costs of the Improvements. Borrower shall deposit such additional money with Lender within _ _[*e.g., five*]_ _ days after its receipt of Lender's written demand. Borrower will not receive any interest on the funds so held.

6.3 *Payment to Lender or Third Parties*. Despite anything to the contrary contained in this Agreement, at Lender's election, without further notice to or authorization by Borrower, Lender may use and disburse Loan funds and Borrower's Deposit to pay or provide, as and when due, any Loan or commitment fees owing to Lender, interest on the Loan, and such other sums as may be owing to Lender or to any third parties with respect to the Loan. Lender will disburse Borrower's Deposit before making further advances on the Loan, provided that any payments to third parties must be, in Lender's judgment, necessary or appropriate to (i) clear liens against the property, or (ii) to pay costs with respect to the Property or the Improvements not in excess of the amounts set forth in the Approved Budget, or (iii) to protect and preserve Lender's security interest in the Property.

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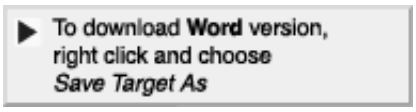
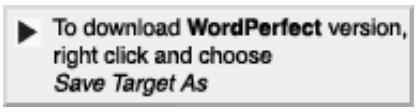
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.39 8. Form: Default and Remedies

§9.39 8. Form: Default and Remedies





9.39-1 Default and remedies

ARTICLE VII

7.1 *Event of Default*. The occurrence of any of the following events shall constitute an Event of Default under this Agreement:

(a) Any default by Borrower in the repayment of any indebtedness owing to Lender for any purpose or reason, which indebtedness is not paid when due under the terms of the Note or other Loan Documents.

(b) Any breach by Borrower of any of the nonmonetary covenants and conditions of this Agreement or of the other Loan Documents, which breach is not cured to Lender's reasonable satisfaction on or before the expiration of any applicable cure period set forth in the Loan Documents.

(c) Any representation, warranty, or disclosure made to Lender by Borrower that proves to be materially false or misleading, whether or not such representation or disclosure appears in this Agreement.

(d) The filing of any claim or lien against the Property or any part thereof, provided, however, that no default shall exist under this Agreement as long as Borrower has fully complied with paragraph _ _[*e.g., 5.8*]_ _.

(e) Failure by Borrower to make any deposit of funds required under this Agreement or other Loan Documents or to pay when due any installment of interest or other sums due under the terms of this Agreement or of the other Loan Documents and after expiration of any applicable grace periods set forth in the Loan Documents.

(f) Any material deviation in the work of construction from the Plans without Lender's approval, or the appearance of defective workmanship or materials, which deviations or defects are not corrected or substantially corrected within _ _[*e.g., 10*]_ _ days after receipt of written notice of these deviations or defects from Lender to Borrower.

(g) The encroachment of any of the Improvements over the Property or setback lines or on an easement, or the encroachment on the Property of any structure on an adjoining property.

(h) The delay or suspension of the work of construction for a period in excess of that permitted under paragraph _ _[*e.g., 5.2*]_ _, or the failure of the work of construction to proceed with due diligence and in substantial accordance with the schedule of completion set forth on Exhibit _ _[*e.g., B-1*]_ _, subject to Unavoidable Delay (as defined in paragraph _ _[*e.g., 5.2*]_ _), or to complete by the Completion Date or such later date as Lender may elect.

(i) The service of a bonded stop notice on Lender that is not released or the Lender's not receiving an acceptable counterbond within _ _[*e.g., 10*]_ _ days of Borrower's receipt of written notice from Lender that such bonded stop notice has been served on Lender.

(j) The occurrence of any event that in Lender's judgment materially adversely affects (i) the ability of Borrower to perform any of its obligations under this Agreement or under any of the Loan Documents, including, without limitation, the occurrence of any event of dissolution or termination of Borrower, of any member of Borrower, or of any Guarantor; (ii) the business or financial condition of Borrower, or of any member of Borrower, or of any Guarantor; or (iii) the operation or value of the Property.

(k) Failure to complete construction of the Offsite Work in accordance with the Plans as required under

paragraph _ _[*e.g., 5.2*]_ _.

(l) Failure to timely comply with the provisions of paragraphs _ _[*e.g., 5.16 and 5.17*]_ _.

(m) The discovery of hazardous or toxic substances on, under, or about the Property in violation of applicable laws or ordinances.

(n) The expenditure by Borrower of any portion of the Loan Proceeds on any item, other than the items listed on the Approved Budget.

(o) Borrower's failure to timely comply with the conditions and obligations contained in Article _ _[*e.g., IV*]_ _.

(p) The sale, transfer, hypothecation, encumbrance, or assignment by the Borrower of its interest in all or any portion of the Property whether voluntarily or involuntarily, or by operation of law in violation of the Deed of Trust.

(q) Any transfer, sale, encumbrance, or assignment of any membership interest in Borrower in violation of the Deed of Trust.

(r) The Borrower's failure to promptly commence construction of the Improvements or to satisfy all of the conditions of this Agreement with respect to disbursement of Loan proceeds for costs of such construction, on or before the expiration of _ _[*e.g., 30*]_ _ days after the date of this Agreement.

(s) The occurrence of a default under the terms of the Construction Contract by either Borrower or General Contractor.

(t) Failure to complete construction of the Improvements in substantial accordance with the Plans on or before the Completion Date.

7.2 *Remedies*. On the occurrence of an Event of Default, Lender may, in addition to any other remedies that Lender may have under this Agreement or under the Loan Documents or by law, at its option and without prior demand or notice, take any or all of the following actions:

(a) Immediately terminate any further advance of Loan funds under this Agreement, and from time to time apply all or any part of the undisbursed Loan funds to payment of accrued interest under the Note or on any other obligations of Borrower under this Agreement or under the Loan Documents.

(b) Declare the Note immediately due and payable and record a notice of default under the Deed of Trust.

(c) Enter on the Property and complete construction of the Improvements in accordance with the Plans with such changes as Lender may from time to time and in its judgment deem appropriate, all at the risk and expense of Borrower. Lender shall have the right at any time to discontinue any work commenced by it in respect to the Improvements or to change any course of action undertaken by it and not be bound by any limitations or requirements of time whether set forth in this Agreement or otherwise. Lender shall have the right and power (but shall not be obligated) to assume any construction contract made by or on behalf of Borrower in any way relating to the Improvements and to take over and use all or any part of the labor, materials, supplies, and equipment contracted for by or on behalf of Borrower whether or not previously incorporated into the Improvements, all in the discretion of Lender. In connection with any work of construction undertaken by Lender pursuant to the provisions of this paragraph _ _[*e.g., 7.2(c)*]_ _, Lender may (i) engage builders, contractors, architects, engineers, and others for the purpose of furnishing labor, materials, and equipment in connection with the work of construction; (ii) pay, settle, or compromise all bills or claims that may become liens against the Property or that have been or may be incurred in any manner in connection with completing construction of the Improvements or for the discharge of liens, encumbrances, or defects in title of the Property; and (iii) take such other action, including the employment of watchmen to protect the Improvements, or refrain from taking action under this Agreement as Lender may in its discretion determine from time to time. Borrower shall be liable to Lender for all reasonable sums paid or incurred for completing construction of the Improvements, whether the same shall be paid or incurred pursuant to the provisions of this paragraph _ _[*e.g., 7.2(c)*]_ _ or otherwise, and all payments made or liabilities incurred by Lender under this Agreement of any kind shall be paid by Borrower to Lender on demand, with interest at the Default Rate set forth in the

Note, and all of such payments shall be deemed and shall constitute advances under this Agreement and be secured by the Loan Documents. For the purpose of carrying out the provisions and exercising the rights, powers, and privileges granted by this paragraph _ _[*e.g., 7.2(c)*]_ _, Borrower unconditionally and irrevocably constitutes and appoints Lender its true and lawful attorney-in-fact to enter into such contracts, perform such acts, and incur such liabilities as are referred to in this paragraph _ _[*e.g., 7.2(c)*]_ _ in the name and on behalf of Borrower. This power of attorney is coupled with an interest.

(d) When substantial deviations from the Plans appear that have not been approved as set forth in this Agreement, or defective or unworkmanlike labor or materials are being used in the construction of the Improvements, or on receipt of knowledge of encroachments to which there has been no consent, Lender shall have the right immediately to order stoppage of the construction and demand that such condition(s) be corrected. After issuance of such an order in writing, no further work shall be done on the Improvements when there is a substantial deviation from the Plans that has not been approved as set forth in this Agreement or when there is defective or unworkmanlike labor or materials, without the prior written consent of Lender unless and until said condition has been fully corrected.

(e) Foreclose on any security for the Loan without waiving its rights to proceed against other security or other entities or individuals directly or indirectly responsible for repayment of the Loan, or waive any and all security for the Loan as Lender may in its discretion so determine, and pursue any such other remedy or remedies as Lender may so determine to be in its best interest, including, without limitation, appointment of a receiver pursuant to the Deed of Trust. All remedies of Lender provided for in this Agreement and in any other Loan Document are cumulative and shall be in addition to all other rights and remedies provided by law. The exercise of any right or remedy by Lender under this Agreement shall not in any way constitute a cure or waiver of default under this Agreement or under any other Loan Document or invalidate any act done pursuant to any notice of default, or prejudice Lender in the exercise of any of its rights under this Agreement or under any other Loan Documents unless, in the exercise of these rights, Lender realizes all amounts owed to it under such Loan Documents.

Comment: Paragraph 7.1(f) of this form provides that a material deviation in the construction work from the plans and defective work or materials that are not corrected within ten days after receipt of notice each constitute an event of default. See discussion of defective work in §9.30.

Paragraph 7.1(s) of the form is a cross-default provision, stating that a default under the construction contract is an event of default under the loan agreement. The borrower's counsel should attempt to negotiate a modification to this providing that a default under the construction contract does not result in an event of default under the loan agreement until all applicable notice and cure periods have expired. The lender may be willing to agree to this change if the lender has negotiated additional cure rights in the separate collateral assignment of the construction contract signed by the parties at closing (for form, see §9.48). However, the construction lender will want to make sure that it has the right to cure the borrower's defaults under the construction contract before the contractor can terminate it.

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§9.40 9. Form: Miscellaneous

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ARTICLE VIII

8.1 *No Waiver*. No waiver of any default or breach by Borrower under this Agreement shall be implied from (a) Lender's failure to take action on account of such default if such default persists or is repeated, or (b) Lender's funding of one or more advances when Borrower is in default or breach of its obligations under this Agreement. No express waiver shall affect any default other than the default specified in the waiver and shall be operative only for the time and to the extent stated in the waiver. Waivers of any covenant, term, or condition contained in this Agreement shall not be construed as a waiver of any subsequent breach of the same covenant, term, or condition. The consent or approval by Lender to, or of, any act by Borrower requiring further consent or approval shall not be deemed to waive or render unnecessary the consent or approval to, or of, any subsequent similar act.

8.2 *Successors and Assigns*. This Agreement is made and entered into for the sole protection and benefit of Lender and Borrower and their successors and assigns, and no other person or persons shall have any right of action under this Agreement. The terms of this Agreement shall inure to the benefit of the successors and assigns of the parties, provided, however, that the Borrower's interest under this Agreement cannot be assigned or otherwise transferred without the prior consent of Lender.

8.3 *Notices*. All notices under this Agreement shall be in writing and sent by personal delivery, nationally recognized overnight delivery service, certified or registered mail, return receipt requested, or by facsimile transmission with a "hard" copy delivered within the next _ _[*e.g., two*]_ _ business days addressed as follows:

If to Borrower: _____
_____
_____
Attention:_____
Fax No.: (___) ____-_____

If to Lender: _____
_____
_____
Attention:_____
Fax No.: (___) ____-_____

Notices shall be deemed given on receipt at the address set forth above. Notice of any changes of address or of the person to whom notices are to be sent shall be given in the manner set forth in this paragraph _ _[*e.g., 9.3*]_ _.

8.4 *Authority to File Notices*. Borrower irrevocably appoints, designates, and authorizes Lender as its agent (this agency being coupled with an interest) to file for record any notices of completion, cessation of labor, or file or send to any third party any other notice or documents or take any other action that Lender reasonably deems necessary or desirable to protect its interest under this Agreement, or under the Loan Documents, and will on request by Lender, execute such additional documents as Lender may require to further evidence the grant of this right to Lender.

8.5 *Time*. Time is of the essence of this Agreement.

8.6 *Signs*. Lender reserves the right to publicize the making of the Loan by Lender. Borrower shall not place

signs on the Property evidencing that construction financing is being provided by Lender without Lender's prior written consent.

8.7 *Amendments, Termination, Waiver*. No amendment, supplement, termination, or waiver of any provision of this Agreement or of any of the Loan Documents, nor consent to any departure by Borrower from the terms of this Agreement or of any of the other Loan Documents, shall be effective unless it is in writing and signed by Lender and Borrower, and then such waiver or consent shall be effective only in the specific instance and for the specific purpose for which given.

8.8 *Headings*. The article and paragraph headings in this Agreement are for reference only and in no way define, limit, extend, or interpret the scope of this Agreement or of any particular article or section.

8.9 *Number and Gender*. When the context in which the words are used in this Agreement indicate that such is the intent, words in the singular number shall include the plural and vice versa. References to any one gender shall also include the other gender, if applicable, under the circumstances.

8.10 *Validity*. If any provision of this Agreement is held to be invalid, that holding shall not affect in any respect the validity of the remainder of this Agreement.

8.11 *Governing Law*. This Agreement shall be governed by and construed in accordance with the laws of the State of California.

8.12 *Survival of Warranties*. All agreements, representations, and warranties made in this Agreement shall survive the execution and delivery of this Agreement, of the Loan Documents, of the Environmental Indemnity and the making of the Loan under this Agreement and continue in full force and effect until the obligations of Borrower under this Agreement and the indebtedness evidenced by the Note have been fully paid and satisfied.

8.13 *Relation to Commitment Letter*. The terms and provisions of this Agreement, the Loan Documents, and the Environmental Indemnity supersede any inconsistent terms and conditions of the commitment letter issued by Lender to Borrower, provided, however, all other terms and conditions of this commitment and Borrower's obligations under the commitment shall survive the execution and delivery of this Agreement, the Loan Documents, and the Environmental Indemnity, and any failure of the Borrower to perform any such obligations shall constitute a default under this Agreement.

8.14 *Attorney Fees*. Should any litigation or other dispute resolution process be commenced between the parties or their representatives concerning any provision of this Agreement or the rights and duties of any person or entity in relation to this Agreement, the party or parties prevailing in such litigation, whether by final judgment or out-of-court settlement, shall be entitled, in addition to such other relief as may be granted, to an award of all reasonable attorney fees and costs incurred in such litigation, including, without limitation, fees and costs incurred with regard to postjudgment motions, contempt proceedings, garnishment, levy, and debtor and third party examinations, discovery, and bankruptcy litigation, without regard to any schedule or rule of court purporting to restrict such an award.

8.15 *Incorporation of Exhibits*. All Exhibits referred to in this Agreement and attached to it are incorporated into this Agreement by reference as if fully set forth in this Agreement.

8.16 *Right to Participate Loan*. Lender shall retain the right at all times, with or without Borrower's consent, to grant participations in all or any portion of the Loan to any other financial institution acceptable to Lender. Borrower acknowledges that Lender has the right to share any and all information concerning Borrower or any Guarantor with any prospective loan participant.

8.17 *Venue and Forum*. In the event that any legal action should be filed by either party against the other, the venue and forum for such action shall be the Superior Court of the State of California for the County of _ _ _ _. Each of the persons and entities who are shareholders or partners of Borrower also agree to this venue and forum and further agree that, if they are not residents of California at the time of such actions, service of process may be made on them by delivery via United States registered or certified mail.

8.18 *Legal Relationships*. The relationship between Borrower and Lender is that of lender and borrower, and no partnership, joint venture, or other similar relationship shall be inferred from this Agreement. Borrower shall not have the right or authority to make representations, to act, or to incur debts or liabilities on behalf of

Lender. Borrower is not executing this Agreement as an agent or nominee for an undisclosed principal, and no third party beneficiaries are or shall be created by the execution of this Agreement.

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§9.41 10. Form: Signatures

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9.41-1 Signatures

IN WITNESS WHEREOF, Borrower and Lender have executed this Agreement as of the date first written above by and through their duly authorized representatives.

BORROWER _ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*state of organization*]_ _ **limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

LENDER _ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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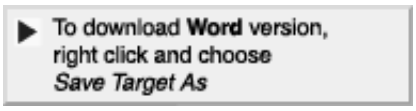
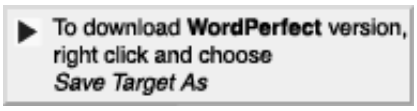
B. Form: Exhibits to Loan Agreement

§9.42 1. Form: Legal Description of Property (Exhibit A)





9.42-1 Legal description of property

EXHIBIT A

Exhibit A to the construction loan agreement is a description of the real property. It is a safe practice to copy the legal description from the final title commitment received from the title company so that there is less chance of error in the legal description.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.43 2. Form: Improvements and Plans (Exhibit B)

§9.43 2. Form: Improvements and Plans (Exhibit B)

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9.43-1 Improvements and plans

EXHIBIT B

IMPROVEMENTS AND PLANS

The Improvements:

The Plans	**See Exhibit B-2 attached hereto**
***Guarantors*:**	**_____, individually, and _____, individually**
Permanent Loan Commitment:	**_____**
Construction Commence Date:	**_____**
Construction Completion Date:	**_____**
Change Order Amounts:	**_____**
Performance and Material and Labor Bonds:	**_____**

9.43-2 Completion dates

EXHIBIT B-1

COMPLETION DATES

_ _[*Name of architect*]_ _ **has furnished these completion dates for various components of the Improvements. If there is a change in these completion dates, the Borrower agrees to furnish Lender with a new schedule reflecting said changes.**

1. **Rough Grading Completed: _____**
2. **Footing Poured: _____**
3. **Slab Poured: _____**
4. **Framing Completed: _____**
5. **Rough Plumbing & Electrical Completed: _____**
6. **Roof Completed: _____**
7. **Drywall Installed: _____**

8. Exterior Lath Completed: _____

9. Interior Paint (color): _____

10. Exterior Paint (color): _____

11. Appliances, Cabinets, Cupboards, Countertops: _____

12. Landscaping, Walkways, Driveways Completed: _____

13. Scheduled Completion Date: _____

ARCHITECT:

_____
ARCHITECTS, a _____

9.43-3 The plan (exhibit B-2)

EXHIBIT B-2

THE PLANS

A copy of the plans should be attached to the loan agreement. Usually the borrower or the architect provides a list of the plans, which are described by referring to each sheet.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.44 3. Form: Approved Budget (Exhibit C)

§9.44 3. Form: Approved Budget (Exhibit C)

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9.44-1 Approved budget (exhibit C)

EXHIBIT C

APPROVED BUDGET

A copy of the approved budget should be attached to the loan agreement as an exhibit. This exhibit is usually generated by the borrower.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.45 4. Form: Schedule of Loan Documents (Exhibit D)

§9.45 4. Form: Schedule of Loan Documents (Exhibit D)

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9.45-1 Schedule of loan documents

EXHIBIT D

SCHEDULE OF LOAN DOCUMENTS

Exhibit "D" to CONSTRUCTION LOAN AGREEMENT between _ _[*name*]_ _, a California limited liability company, as Borrower, and _ _[*name*]_ _, a California corporation, as "Lender," dated as of _ _[*date*]_ _ (Agreement).

The documents enumerated below and any amendments, modifications, and supplements to these documents that have received the prior written consent of Lender and any documents executed in the future that are approved by Lender and that recite that they are "Loan Documents" for purposes of this Agreement are collectively referred to as the "Loan Documents." The term Loan Documents does not include the Environmental Indemnity Agreement.

1. This Agreement;

2. The Promissory Note Secured by Construction Deed of Trust (Note), of even date with this Agreement, in the original principal amount of the Loan, executed by Borrower, payable to the order of Lender;

3. Construction Deed of Trust, Security Agreement, Assignment of Rents and Fixture Filing (Deed of Trust), dated as of the date of this Agreement, executed by Borrower, as Trustor, to _ _[*name of title company*]_ _, as Trustee, for the benefit of Lender, as Beneficiary;

4. Assignment of Leases, dated as of the date of this Agreement, executed by Borrower in favor of Lender;

5. State of California Uniform Commercial Code Financing Statement—Form UCC-1, executed by Borrower, as Debtor, and Lender, as Secured Party;

6. Security Agreement, dated as of the date of this Agreement, executed by Borrower in favor of Lender;

7. Environmental Indemnity, dated as of the date of this Agreement, executed by Borrower in favor of Lender;

8. Repayment Guaranty, dated as of the date of this Agreement, executed by _ _[*name*]_ _ and _ _[*name*]_ _ as Guarantor, in favor of Lender;

9. Completion Guaranty, date as of the date of this Agreement, executed by _ _[*name*]_ _ and _ _[*name*]_ _ as Guarantor, in favor of Lender;

10. Assignment of Contracts, dated as of the date of this Agreement, executed by Borrower in favor of Lender;

11. Contractor's Consent to Assignment of Construction Contract, dated as of the date of this Agreement, executed by Contractor in favor of Lender;

12. Architect's Consent to Assignment of Architect's Agreement, dated as of the date of this Agreement, executed by Architect in favor of Lender;

13. Collateral Assignment of Management Agreement (to be provided postclosing);

14. Consent to Collateral Assignment of Management Agreement (to be provided postclosing);

15. Zoning Certificate;

16. General Requirements for Surveys;

17. Non-Foreign Certificate—Transferor's Certification of Non-Foreign Status, executed by Borrower;

18. Signature Authorization Form, dated _ _[*date*]_ _, executed by _ _[*name*]_ _ ;

19. Action by Written Consent of Members of _ _[*name of borrower*]_ _, a California limited liability company;

20. Request for Subsequent Advance;

21. Construction Loan Disbursement Agreement;

22. Guarantor's Estoppel Certificate, dated as of the date of this Agreement, executed by _ _[*name*]_ _ and _ _[*name*]_ _, as Guarantor in favor of Lender;

23. Add other borrowing resolutions as may be needed if the member or borrower is an entity.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.46 5. Form: Tenant Leases (Exhibit E)

§9.46 5. Form: Tenant Leases (Exhibit E)

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9.46-1 Tenant leases (exhibit e)

EXHIBIT E

TENANT LEASES

List Tenant Leases here.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/ VII. COLLATERAL ASSIGNMENTS/§9.47 A. Form: Collateral Assignment of Design Professional's Contract, Plans and Specifications, and Tests, and Design Professional's Agreement and Consent to Assignment

VII. COLLATERAL ASSIGNMENTS

§9.47 A. Form: Collateral Assignment of Design Professional's Contract, Plans and Specifications, and Tests, and Design Professional's Agreement and Consent to Assignment

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9.47-1 Collateral assignment of design professional's contract, plans and specifications, and tests, and design professional's agreement and consent to assignment

THIS COLLATERAL ASSIGNMENT OF DESIGN PROFESSION AL'S CONTRACT, PLANS AND SPECIFICATIONS, AND TESTS, AND DESIGN PROFESSIONAL'S AGREEMENT AND CONSENT TO ASSIGNMENT, as the same may from time to time be modified, supplemented, or amended (Assignment), is made as of _ _[*date*]_ _, by and among _ _[*name*]_ _, a California limited liability company (Borrower), _ _[*name*]_ _, a California corporation (Lender), and _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Design Professional).

FOR VALUE RECEIVED, and as additional security for the obligations of Borrower, to and for the benefit of Lender, as more fully provided in that Construction Loan Agreement of even date herewith (Loan Agreement) providing for a loan to Borrower in the amount of _ _[*dollar amount*]_ _ (the Loan), Borrower transfers, assigns, and conveys to and grants a security interest in favor of, Lender, as additional security for the Loan, subject to the terms and conditions contained in this Assignment, in all of the right, title, and interest of Borrower in and to (i) that certain Design Professional's Contract, bearing the title _ _[*title*]_ _, dated _ _[*date*]_ _ (Design Contract), between Borrower and Design Professional, together with all amendments, addenda, supplements, modifications, change orders, and extensions of the Design Contract, whether now or hereafter existing, which Design Contract was prepared for the construction of the "Project" identified in the Loan Agreement (all terms defined in the Loan Agreement are used with the same meanings in this Assignment); (ii) those certain plans and specifications, drawings, and design documents listed and identified in Exhibit A to this Assignment, together with all permitted amendments, addenda, supplements, modifications, and change orders to the plans and specifications, whether now or hereafter existing (Plans and Specifications); and (iii) any and all tests, studies, results and reports, and contracts and agreements therefor (Tests) performed and prepared in contemplation of the aforesaid construction, including any and all addenda, supplements, amendments, and modifications to the Tests, whether now or hereafter existing. The Design Contract, the Plans and Specifications, and the Tests are referred to in this Assignment as the Documents.

1. Design Professional acknowledges that the Loan to Borrower includes funds to pay for the construction of the Project and to pay Design Professional the sums due to it under the Design Contract, assuming proper performance by Design Professional under the Design Contract. Design Professional acknowledges that Design Professional's execution and delivery of this Assignment is a material inducement to Lender to make the Loan, and without execution and delivery of this Assignment, Lender will not make the Loan. Design Professional consents to the Borrower's Assignment to Lender of the Design Contract, Plans and Specifications, and Tests, and to each and all of the terms and conditions of this Assignment, despite any terms to the contrary in the Design Contract.

2. Lender may exercise its rights under this Assignment on the occurrence of an Event of Default under the Loan Agreement. Immediately on written notice to Borrower and Design Professional that Lender is exercising its rights under this Assignment, Lender shall succeed to all Borrower's right, title, and interest in and to the Documents, provided, however, that Lender does not assume any of Borrower's obligations or duties under or in connection with Design Contract until and unless Lender shall exercise its rights under this Assignment.

3. Design Professional agrees that, if Lender delivers written notice to Design Professional that Lender is exercising its rights under this Assignment, then (i) Lender is authorized to use the Plans and Specifications for the purpose of completing construction of, and for the maintenance, protection, and improvement of, the Project as contemplated by the Loan Agreement, without additional cost or expense; and (ii) Design

Professional will continue, at Lender's direction, to perform services for Lender in accordance with the terms of the Design Contract, provided that Lender pays to Design Professional the fees for those services rendered to Lender in accordance with the terms of the Design Contract, despite any contrary instructions, direction, or requests from Borrower. However, it is expressly understood that Lender neither assumes nor has any obligation to Design Professional to exercise its rights under this Assignment or to declare a default under the Loan Agreement, but that the option to exercise such rights or declare a default rests in the sole and absolute discretion of Lender. If Lender exercises its rights under this Assignment, Design Professional agrees that other than for the payment of fees as set forth in this section, Lender shall have no personal obligations or liabilities under the Design Contract or this Assignment, and the sole right and remedy of Design Professional as against Lender under the Design Contract or under this Assignment shall be enforcement of Design Professional's lien rights, if any, against the property described in the Design Contract.

4. This Assignment includes all Plans and Specifications and Tests prepared now or hereafter with respect to the Project in which either Borrower or Design Professional has or will have an interest, and Lender shall have the right to use the same in connection with the Project and the Land.

5. Borrower, with the consent of Design Professional, has full power and authority to make this Assignment. Borrower and Design Professional certify that the Design Contract is in full force and effect and agree they shall not modify, amend, or terminate the Design Contract without the prior written consent of Lender. Borrower agrees to make, execute, and deliver all additional instruments that may be necessary to satisfy the intent and purposes of this Assignment and to perfect the assignment made hereby.

6. Borrower further irrevocably appoints Lender as Borrower's attorney-in-fact to exercise any or all of Borrower's rights in, to, and under the Documents, to give appropriate receipts, releases, and satisfactions on behalf of Borrower in connection with Design Professional's performance under the Design Contract and otherwise under the Documents, and to do any or all other acts, in Borrower's name or in Lender's own name, that Borrower could do under any or all of the Documents with the same force and effect as if this Assignment had not been made. This power of attorney is coupled with an interest.

7. At the date of this Assignment, Design Professional represents and warrants that it has no counterclaim, right of set-off, defense, or like right against Borrower or Lender, and that Design Professional has been paid all amounts due for its work as of this date. Borrower agrees to make the required payments under the Design Contract. Design Professional agrees that if Lender exercises any of its rights under the Assignment, Design Professional will perform the obligations specified to be performed by it under the Design Contract for Lender notwithstanding any counterclaim, right of set-off, defense, or like right of Design Professional against Borrower or Borrower's default under, or breach of, the Design Contract. Design Professional agrees that, without Lender's prior written consent, it will not use or suffer or permit the Plans and Specifications to be used for any purpose other than in connection with the construction of the Project.

8. Design Professional agrees that it will not terminate the Design Contract or cease to perform its work under the Design Contract for any reason, including, but not limited to, Borrower's failure to make any payments to Design Professional, without giving written notice to Lender of such intention to terminate or cease performing its work at least _ _[*e.g., 30*]_ _ days before that termination, in order that Lender may exercise its rights as described in this Assignment.

9. Design Professional, from time to time and at no cost to Lender, shall furnish to Lender on written request any information or material Design Professional may have regarding the Project, including, without limitation, (i) any information Design Professional may have regarding defects in workmanship or materials incorporated into or provided for the Project; (ii) Design Professional's estimate(s) of the stage(s) of completion of construction of the Project; (iii) any deviations or variations in construction of the Project from the Plans and Specifications; (iv) any information Design Professional may have regarding any defaults by Borrower, the general contractor, or any subcontractor under the Design Professional Contract, the Engineering Agreement or the Construction Contract (as defined in the Loan Agreement) (collectively, the Construction Contracts); (v) any information Design Professional may have regarding construction practices or conditions in effect at the Project that Design Professional regards as unsafe or dangerous; and (vi) any claims of nonpayment by any person furnishing labor or material in connection with the construction of the Project.

10. Design Professional agrees to indemnify, defend, and hold Lender harmless from and against any and all claims, losses, costs, damages, or liability, including reasonable attorney fees and litigation expenses, that Lender may sustain or incur arising out of or from any act of omission, commission, or deviation by Design

Professional in connection with the Project from the minimum standards of care applicable to architects in their performance of professional services, which indemnity specifically includes indemnification of Lender for any error, omission, or negligent act of Design Professional. In connection with this indemnity, Design Professional assigns to Lender any right or claim Design Professional may have against any person, firm, partnership, corporation, or other entity that has or will provide Design Professional with professional services in connection with the Project, including, but not limited to, any civil, mechanical, structural, electrical, or soils engineer to include, but not be limited to, any claim Design Professional may have against such person, firm, partnership, corporation, or other entity for any negligent action or inaction, carelessness, inattention, or breach of contract with Design Professional.

11. Design Professional warrants and represents to Lender that the Plans and Specifications identified on Exhibit A were prepared by Design Professional and constitute all plans, specifications, drawings, models, or other work product prepared or possessed by Design Professional that pertain to the Project and that all of such plans, drawings, and other work product have been fully paid for and are the property of Borrower. The Plans and Specifications are complete in all respects and contain all details requisite for the construction of the Project which, when built in accordance with the Plans and Specifications, shall be ready for use and occupancy for its intended purpose in compliance with all applicable laws, statutes, ordinances, codes, rules, regulations, decrees, and orders. In addition, the Plans and Specifications have been prepared in a manner that in all respects is consistent with accepted architectural practices. Design Professional expressly agrees that it shall not modify, amend, or terminate the Design Professional's Contract or modify or amend the Plans and Specifications without the express written consent of Lender.

12. Design Professional certifies the following:

(a) The Plans and Specifications are, and that the Project when completed in accordance therewith will be, in full compliance with all applicable building, zoning, and other laws and ordinances;

(b) The Project, when completed in accordance with the Plans and Specifications, will not encroach on any recorded or visible easement in effect with respect to the Property;

(c) The Plans and Specifications are complete in all respects, containing all detail requisite for the Project which, when built and equipped in accordance with the Plans and Specifications, shall be ready for occupancy;

(d) In the aggregate, the construction contracts contain all detail necessary to provide for all labor, material, and equipment required by the Plans and Specifications (or noting all exceptions from such coverage);

(e) All permits, licenses and governmental approvals necessary for construction of the Project have issued (or noting exceptions from such coverage);

(f) Adequate ingress and egress to and from the Project over public streets and rights-of-way is and will be available during the period of construction of the Project and after construction;

(g) The Project, when completed in accordance with the Plans and Specifications, will comply with all covenants, conditions, and restrictions of record; and

(h) Any offsite improvements necessary for the use and operation of the Project have been noted and described in the Plans and Specifications.

13. Design Professional shall notify Lender in writing of any breach of the Design Contract by Borrower or of any receipt by Design Professional of notice from Borrower or any other third party of any claimed breach by Design Professional of the Design Contract.

14. Any notice that any party to this Assignment may desire or be required to give to the other shall be deemed to be an adequate and sufficient notice if given in writing and service is made by either (i) registered or certified mail, postage prepaid, return receipt requested, in which case notice shall be deemed to have been received _ _[*e.g., three*]_ _ business days after deposit to the mail; or (ii) nationally recognized overnight air courier, next-day delivery, prepaid, in which case such notice shall be deemed to have been received _ _[*e.g., one*]_ _ business day following delivery to such courier. All notices shall be addressed to:

If to Lender:

_____
_____
_____

If to Borrower:

_____
_____
_____

If to Design Professional:

_____
_____
_____

or to such other address the party to receive such notice may have furnished to all other parties by notice in accordance with this Assignment. Except as otherwise specifically required in this Assignment, no notice of the exercise of any right or option granted to Lender in this Assignment is required to be given.

15. This Assignment shall bind and inure to the benefit of the successors, assigns, legal and personal representatives, executors, administrators, heirs, and other transferees of the parties to this Assignment.

16. This Assignment may be executed in counterparts, each of which shall be deemed to an original, and such counterparts when taken together shall constitute one agreement.

BORROWER

Date: _ _ _ _ _ _

_ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*state of organization*]_ _ **limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

EXHIBIT A

ATTACH LIST OF PLANS AND SPECIFICATIONS

[NOTE: MUST INCLUDE IN THIS EXHIBIT ALL COMPUTER-RELATED DRAWINGS]

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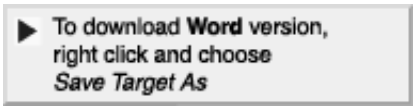
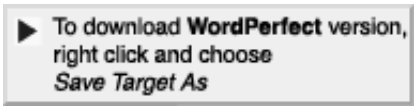
Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.48 B. Form: Collateral Assignment of Construction Contract and Permits, and Contractor's Agreement and Consent to Assignment

§9.48 B. Form: Collateral Assignment of Construction Contract and Permits, and Contractor's Agreement and Consent to Assignment





9.48-1 Collateral assignment of construction contract and permits, and contractor's agreement and consent to assignment

COLLATERAL ASSIGNMENT OF CONSTRUCTION CONTRACT AND PERMITS, AND CONTRACTOR'S AGREEMENT AND CONSENT TO ASSIGNMENT

THIS COLLATERAL ASSIGNMENT OF CONSTRUCTION CONTRACT AND PERMITS, AND CONTRACTOR'S AGREEMENT AND CONSENT TO ASSIGNMENT, as the same may from time to time be modified, supplemented, or amended (Assignment), is made as of _ _[*date*]_ _, by and among _ _[*name*]_ _, a California limited liability company (Borrower), _ _[*name*]_ _, a California corporation (Lender), and _ _[*name*]_ _, a _ _[*type of entity*]_ _ (Contractor).

FOR VALUE RECEIVED, and as additional security for the obligations of Borrower, to and for the benefit of Lender, as more fully provided in that Construction Loan Agreement of even date with this Assignment (Loan Agreement) made by Borrower and Lender providing for a Loan to Borrower (Loan), Borrower assigns, transfers, sets over to, and grants a security interest in favor of Lender, as additional security for the Loan, subject to the terms and conditions contained in this Assignment, in all of Borrower's right, title, and interest in and to that certain Construction Contract bearing the title _ _[*name*]_ _ and dated _ _ _ _ (Construction Contract), between Borrower and Contractor, together with all amendments, addenda, supplements, modifications, change orders, extras and extensions to the Construction Contract, whether made now or hereafter, which Construction Contract provides for the construction of the Project identified in the Loan Agreement (all terms defined in the Loan Agreement are used with the same meanings in this Assignment), together with the Permits (as defined in this Assignment).

1. Contractor acknowledges that the Loan includes funds to pay for the construction of the Project and to pay Contractor sums due to it under the Construction Contract, assuming proper and timely performance by Contractor under the Construction Contract. Contractor acknowledges that the execution and delivery of this Assignment by Contractor is a material inducement to Lender to make the Loan, and without execution and delivery of this Assignment, Lender will not make the Loan. Contractor consents to the Borrower's assignment of the Construction Contract and Permits to Lender, and Contractor agrees to each and all of the terms and conditions in this Assignment, despite any terms to the contrary in the Construction Contract.

2. Assuming proper and timely performance by Contractor under the Construction Contract, Lender may exercise its rights under this Assignment on the occurrence of an Event of Default under the Loan Agreement, and immediately on written notice to Borrower and Contractor that Lender is exercising its rights under this Assignment, Lender shall succeed to all Borrower's right, title, and interest to and under the Construction Contract, provided, however, that Lender does not assume any of Borrower's obligations or duties under or in connection with the Construction Contract until and unless Lender shall exercise its rights under this Assignment.

3. Contractor agrees that, if Lender delivers written notice to Contractor that Lender is exercising its rights under this Assignment, Contractor will continue at Lender's direction to perform services for Lender pursuant to and in accordance with the terms of the Construction Contract, provided that there are no material uncured defaults by Borrower under the Construction Contract at the time of Lender's exercise of its rights under this Assignment, or if there are any existing material defaults, Lender cures any such defaults within _ _[*e.g., 14*]_ _ business days following the later to occur of (i) Lender's exercise of its rights under this Assignment and (ii) receipt by Lender of written notice of default from the Contractor of such defaults and provided further that Lender pays to Contractor the fees for those services rendered to Lender in accordance with the terms of the

Construction Contract, irrespective of any contrary instructions, direction, or requests from Borrower. It is expressly understood that Lender neither assumes nor has any obligation to Contractor to exercise its rights under this Assignment or to declare an Event of Default under the Loan Agreement, but that the option to exercise such rights or to declare a default rests in the sole and absolute discretion of Lender. If Lender exercises its rights under this Assignment, Contractor agrees that, other than for the payment of fees as set forth in this section, Lender shall have no personal obligations or liabilities under the Construction Contract or this Assignment, and the sole right and remedy of Contractor as against Lender under the Construction Contract or under this Assignment shall be enforcement of Contractor's lien rights, if any, against the property described in the Construction Contract.

4. Borrower and Contractor each assign to Lender, subject to the terms and conditions of this Assignment, all of their respective right, title, and interest in and to all permits, licenses, approvals, certificates, and consents issued by any governmental or private authority or agency relating to the Project or Property, naming Borrower or Contractor, or in which any one of them has an interest (Permits), and Lender shall have the right to use the same in connection with the Project and the Property, provided that such assignment shall not be effective for any Permit unless and until all fees required to be paid by Borrower or Lender in connection with such Permit have been paid pursuant to the terms of the Construction Contract.

5. Borrower, with the consent of the Contractor, has full power and authority to make this Assignment. Borrower and Contractor certify that the Construction Contract is in full force and effect and they agree not to modify, amend, or terminate the Construction Contract, including, but not limited to, any amendments, supplements, addenda, modifications, change orders, extras, or extensions, without the prior written consent of Lender, except for such change orders or extras, if any, as are specifically allowed under __[*e.g., paragraph 6.2*]__ of the Loan Agreement. Borrower agrees to make, execute, and deliver all such further or additional instruments as may be necessary to satisfy the intent and purposes of this Assignment and to perfect the assignment made hereby.

6. Borrower irrevocably appoints Lender as Borrower's attorney-in-fact to exercise any or all of Borrower's rights in, to, and under the Construction Contract, to give appropriate receipts, releases, and satisfactions on behalf of Borrower in connection with the Contractor's performance under the Construction Contract, and to do any or all other acts, in Borrower's name or in Lender's own name, that Borrower could do under the Construction Contract with the same force and effect as if this Assignment had not been made.

7. Contractor and Borrower certify that the Contract is the only contract executed or currently contemplated to be executed between Contractor and Borrower with respect to the Project and that there will be no additional contracts entered into between Contractor and Borrower with respect to the Project unless prior written approval has been received from Lender.

8. Borrower certifies that the following contract(s) represent any and all of the contract(s) executed or currently contemplated to be executed by Borrower with respect to the Project and that there will be no additional contracts entered into by Borrower with respect to the Project unless prior written approval has been received from Lender:

A. Construction Contract; and

B. _ _[*insert additional contracts*]_ _.

9. At the date of this Assignment, Contractor represents and warrants that it is not aware of any existing counterclaim, right of set-off, defense, or like right against Borrower or Lender, and Contractor has been paid all amounts due for its work as of this date. Borrower agrees to make the required payments and otherwise perform its other obligations under the Construction Contract.

10. Contractor agrees that it will not terminate the Construction Contract or cease to perform its work under it for any reason, including, but not limited to, Borrower's failure to make any payments to Contractor, without first giving written notice to Lender of such intention to terminate or cease performing its work at least _ _[*e.g., 14*]_ _ business days before that termination, in order that Lender may exercise its rights as described in this Assignment.

11. On request from Lender, at or about the time Borrower makes each request to Lender for disbursement of funds in accordance with the Loan Agreement, and at any other time when so requested by Lender,

Contractor shall furnish to Lender (a) written verification that Contractor has paid all amounts due each person furnishing labor or material in connection with the construction of the Project; (b) full and complete lien waivers from Contractor and from each person supplying labor or material in the construction of the Project, or such other persons who have, or may claim, mechanic's or materialmen's lien rights against the Land or the Project; (c) Contractor's affidavit regarding the accuracy of all information identified in (a) and (b) of this paragraph; and (d) any and all other documents reasonably requested by Lender or the Title Company (as defined in the Loan Agreement) to comply with the mechanic's lien laws of the state in which the Project is located. Verification of payment, lien waivers, and Contractor's affidavit shall be in all respects reasonably satisfactory to Lender, in Lender's sole and absolute discretion.

12. Contractor shall construct the Project in strict accordance with the Plans and Specifications, as such Plans and Specifications may from time to time be amended in accordance with the provisions of Section 5 of this Collateral Assignment. Contractor shall not undertake or perform any extra or additional work or furnish any extra or additional materials by extra or change order direction of the Architect, Borrower, or independently, nor shall Contractor in any other manner deviate from the construction of the Project contemplated by the Plans and Specifications and the Construction Contract without the prior written consent of Lender first obtained, except as provided in such change orders or extras, if any, as are specifically permitted without the consent of Lender as provided in Section 5 of this Collateral Assignment.

13. Contractor agrees to indemnify, defend, and hold Lender harmless from and against any and all claims, losses, costs, damages, or liability, including reasonable attorney fees and litigation expenses that Lender may sustain or incur arising out of or from (a) the construction of the Project, (b) the performance or lack of performance by Contractor of the Construction Contract, (c) this Assignment, and (d) each other agreement or undertaking by Contractor in connection with (a) through (c) of this Section, except to the extent caused by the gross negligence or willful misconduct of the Lender.

14. Contractor represents, warrants, and agrees that all necessary licenses or permits have been (or in a timely manner will be) obtained to permit the commencement and completion of construction of the Project, and that all materials and equipment contracted or purchased for delivery to the Land and for use in the construction of the Project, together with all labor contracted or hired for or in connection with such construction shall be used and employed solely on the Land in the construction of the Project in accordance with all of the requirements of the Plans and Specifications.

15. Under no circumstances shall this Assignment be construed to grant third party beneficiary rights or make Lender liable or responsible to any materialman, contractor, subcontractor, sub-subcontractor, or any other person supplying labor, materials, or equipment to, for, under, or on the Land, including, but not limited to, those supplied for utilization in the construction of the Project, or for debts or claims accruing against Borrower or Contractor by any such person or entity. There is no contractual or other relationship, express or implied, between Lender and any materialman, contractor, subcontractor, sub-subcontractor, or any other person supplying labor, materials, or equipment to, for, under, or on the Land, or in connection with the construction of the Project.

16. On the occurrence of any breach of the Construction Contract by Borrower or any receipt by Contractor of notice of any claimed breach by Contractor of the Construction Contract, or any subcontract or agreement for supplying material or equipment, Contractor shall in writing notify Lender of each such claimed breach.

17. Any notice that any party may desire or be required to give to the other shall be deemed to be an adequate and sufficient notice if given in writing and service is made by either (a) registered or certified mail, postage prepaid, return receipt requested, in which case notice shall be deemed to have been received _ _[*e.g., three*]_ _ business days following deposit to the mail; or (b) nationally recognized overnight air courier, next-day delivery, prepaid, in which case such notice shall be deemed to have been received _ _[*e.g., 1*]_ _ business day following delivery to such courier. All notices shall be addressed to:

If to Lender:

_____
_____
_____

If to Borrower:

_____

_____
_____

If to Contractor:

_____
_____
_____

or to such other address the party to receive such notice may have furnished to all other parties by notice in accordance with this Assignment. Except as otherwise specifically required in this Assignment, no notice of the exercise of any right or option granted to Lender in this Assignment is required to be given.

18. This Assignment shall bind and inure to the benefit of the successors, assigns, legal and personal representatives, executors, administrators, heirs, and other transferees of the parties to this Assignment.

19. This Assignment may be executed in counterparts, each of which shall be deemed an original, and such counterparts when taken together shall constitute but one agreement.

BORROWER

_ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*state of organization*]_ _ **limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

CONTRACTOR

__[*Signature*]__
_ _[*Typed name*]_ _

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/9 Construction Loans/§9.49 VIII. FORM: COMPLETION GUARANTY

§9.49 VIII. FORM: COMPLETION GUARANTY

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9.49-1 Completion guaranty

COMPLETION GUARANTY

THIS COMPLETION GUARANTY (Guaranty) is made as of _ _[*date*]_ _, by _ _[*name*]_ _ (Guarantor), to and for the benefit of _ _[*name*]_ _, a _ _[*type of entity*]_ _ having an office at _ _[*address*]_ _ (Lender).

RECITALS:

A. _ _[*name*]_ _ ("Borrower") has requested a loan (Loan) from Lender in the original principal amount of _ _[*dollar amount*]_ _ in accordance with the terms and conditions set forth in that certain Construction Loan Agreement of even date herewith (the Loan Agreement) between Borrower and Lender. The Loan is evidenced by a Promissory Note of even date herewith (Note) made by Borrower in the original principal amount of _ _[*dollar amount*]_ _. The Note is secured by, among other things: (i) that certain Construction Deed of Trust, Security Agreement, Assignment of Rents and Fixture Filing (Deed of Trust), given by Borrower to _ _[*name*]_ _, as Trustee, for the benefit of Lender; and (ii) that certain Assignment of Leases and Rents (Assignment of Leases), executed by Borrower in favor of Lender. Guarantor is also executing a Repayment Guaranty dated of even date herewith in favor of Lender. The Loan Agreement, the Note, the Deed of Trust, the Assignment of Leases, and the Repayment Guaranty together with that certain Environmental Indemnity of even date herewith executed by Borrower and Guarantor in favor of Lender and any other documents, instruments and agreements described in the Loan Agreement as "Loan Documents," including any future modifications to the Loan Documents, are collectively referred to as the "Loan Documents"). Unless defined in this Guaranty, all capitalized terms used in this Guaranty shall have the meanings given to them in the Loan Agreement.

B. Lender is unwilling to make the Loan to Borrower unless Guarantor guarantees to Lender the full and timely completion of the improvements described in the Loan Agreement (the Improvements) pursuant to the terms of the Loan Agreement.

C. Guarantor acknowledges that the making of the Loan by Lender to Borrower provides direct benefits to Guarantor.

NOW, THEREFORE, in consideration of the mutual covenants and agreements contained in this Guaranty and of other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, and in order to induce Lender to make the Loan to Borrower, and intending to be legally bound, Guarantor does unconditionally guarantee, agree, warrant, represent, and covenant unto Lender as follows:

1. GUARANTY.

Guarantor absolutely and unconditionally guarantees to Lender that Borrower shall punctually complete the Improvements, in accordance with the budget, time limits, and plans and specifications set forth or described in the Loan Agreement, and free and clear of all liens, claims, or potential liens against the Property, including any lien or potential lien by any person providing labor or materials to the Improvements (collectively "Impermissible Liens"), and regardless of whether Borrower shall have any defense to the performance or payment of such obligations (collectively the "Guarantor Obligations").

2. EVENTS OF DEFAULT.

The occurrence of any of the following shall constitute a "triggering event" under this Guaranty:

2.1. Borrower fails to proceed with or complete construction of the Improvements in the manner and within the time limits, including any cure periods or extensions of time to perform due to Unavoidable Delays (as defined in the Loan Agreement) as may be set forth in the Loan Documents; or

2.2. Borrower fails to pay all costs of construction of the Improvements in the manner and within the time limits, including any cure periods, set forth in the Loan Documents; or

2.3. Borrower's rights to receive further disbursements under the Loan Documents terminate before the Completion of Construction of the Improvements; or

2.4. Lender take possession of the Property, whether by foreclosure or deed in lieu of foreclosure, before Completion of Construction of the Improvements; or

2.5. Borrower fails to pay, discharge, or otherwise provide for payment of, any Impermissible Lien.

3. COMPLETION OF IMPROVEMENTS BY GUARANTOR.

On the occurrence of any triggering event under this Guaranty, and to the extent Lender so demands in writing, Guarantor shall: (a) diligently and timely complete the Improvements in accordance with the Loan Agreement; (b) perform all other obligations of Borrower under the Loan Agreement and the other Loan Documents; and (c) pay or discharge all Impermissible Liens.

4. DISBURSEMENT OF LOAN PROCEEDS TO GUARANTOR.

Guarantor shall perform all of its obligations under Section _ _[*e.g., 3*]_ _ above, at Guarantor's sole expense; provided, however, that subject to compliance by Guarantor with all of its obligations under this Guaranty, Lender shall, on written request by Guarantor, periodically disburse to Guarantor any undisbursed portion of the Loan Amount proceeds allocated for construction costs, real property taxes and assessments, insurance premiums, and other expenses reasonably necessary to complete construction of the Improvements in accordance with the Plans (as defined in the Loan Agreement), subject to the following conditions:

4.1. Each of the conditions to any such disbursement that are contained in the Loan Agreement shall be satisfied in connection with each such disbursement;

4.2. Guarantor shall have cured all defaults or events of default under the Loan Agreement;

4.3. Borrower shall have consented in writing to such disbursements, and shall have agreed that all amounts disbursed to Guarantor (i) are for the account of Borrower, (ii) are part of the Loan, (iii) are secured by the Deed of Trust, and (iv) may be included in a credit bid by Lender on foreclosure and sale of the Property under the Deed of Trust; and

4.4. Lender shall have received, at no cost to Lender, such endorsements to Lender's Title Policy reasonably satisfactory to Lender, confirming the continuing validity and priority of the Deed of Trust (if not previously foreclosed).

5. COMPLETION OF IMPROVEMENTS BY LENDERS.

On the occurrence of any triggering event under this Guaranty, in lieu of making demand on Guarantor as provided in Section _ _[*e.g., 3*]_ _ above, Lender may, in its sole and absolute discretion, elect on giving Guarantor _ _[*e.g., 5*]_ _ business days prior notice of Lender's election to do so, perform any or all of Guarantor's obligations under this Guaranty by itself, through an agent, or by entering into contracts with third parties. In completing any Improvements under this Section, Lender shall have the right, without notice to or consent of Guarantor, (a) to make such changes to the budget, time limits, and plans and specifications for the Improvements as may be required or imposed by any governmental agency, law, or restriction affecting the Property or as Lender reasonably deems appropriate; (b) to modify or terminate existing construction contracts; and (c) to expend such sums and perform such other acts as Lender, in its reasonable discretion deems necessary or proper to complete all or any portion of the Improvements. Guarantor shall reimburse Lender from time to time, within _ _[*e.g., 10*]_ _ days of each written demand by Lender, for all reasonable costs and expenses incurred by Lender under this Section regardless of whether any such costs and expenses are contemplated by, or in excess of the amounts set forth in, the Loan Documents. Guarantor shall pay

interest on all such reimbursable costs and expenses from the date Lender incurs such costs and expenses, at the Default Rate described in the Deed of Trust.

6. DEFAULT AND COMMENCEMENT OF LAWSUIT BY LENDERS; MEASURE OF DAMAGES.

6.1. *Default*. The following events shall constitute a Default under this Guaranty:

(a) The failure of Guarantor to pay to Lender any sums as and when due under this Guaranty; and

(b) The failure of Guarantor to perform any of the obligations under this Guaranty not involving the payment of money for a period exceeding _ _[*e.g., 10*]_ _ days after receipt of written notice from Lender, notifying Guarantor of such default and giving Guarantor an opportunity to cure such default during such _ _[*e.g., 10*]_ _-day cure period.

6.2. *Remedies*. At any time after the occurrence of a triggering event under this Guaranty and the occurrence of a Default under this Guaranty, Lender may commence a lawsuit against Guarantor to compel Guarantor to perform its obligations under this Guaranty and/or to recover damages under this Guaranty. Lender's damages shall include (a) the costs of completing the Improvements and/or correcting any construction defects, (b) damages arising from any delay in completing the Improvements, including interest, taxes and insurance premiums, and (c) Lender's reasonable attorney fees and costs. Lender need not perform any work on the Improvements before commencing such a lawsuit. Lender shall have no obligation to accept any offer of performance by Guarantor to perform work on the Improvements at any time, and no such offer shall constitute a defense to Lender's claims for damages against Guarantor. GUARANTOR EXPRESSLY ACKNOWLEDGES THAT THE MEASURE OF LENDER'S DAMAGES FOR BREACH OF THIS GUARANTY SHALL BE BASED ON THE COSTS OF COMPLETING THE IMPROVEMENTS, NOT THE EXTENT TO WHICH COMPLETING THE IMPROVEMENTS WOULD INCREASE THE VALUE OF THE PROPERTY.

7. DISCHARGE OF IMPERMISSIBLE LIENS.

Guarantor shall reimburse Lender for all of Lender's costs reasonably incurred in discharging Impermissible Liens. Without limiting the generality of the foregoing, Guarantor shall reimburse Lender to the extent Lender is required by law to turn over to laborers or suppliers on the Improvements any Loan proceeds allocated and/or paid to Lender pursuant to the Loan Agreement.

8. INDEMNITY.

Guarantor shall defend, indemnify, and hold Lender harmless from all claims, demands, causes of action, liabilities, losses, costs, and expenses, including costs of suit and reasonable attorney fees (collectively "Losses") arising from or in connection with any act or failure to act by Guarantor in connection with this Guaranty, excluding any losses resulting solely from the gross negligence or willful misconduct of Lender.

9. SUBSEQUENT ACTS BY LENDERS.

Lender may, at its sole and absolute discretion and without notice to Guarantor, take any action that might otherwise be deemed a legal or equitable release or discharge of Guarantor's obligations under this Guaranty without either impairing or affecting the liability of Guarantor under this Guaranty, which actions might include, by way of illustration and not limitation:

9.1. Modification of any Loan Document in any form whatsoever, including, without limitation, the renewal, extension, acceleration, or other change in time for payment of the Obligations (as defined in the Deed of Trust) of Borrower under the Loan Documents, increase or decrease of the rate of interest on the Obligations, or other change in the terms of such Obligations or any part of them;

9.2. The acceptance of partial payment of the Obligations;

9.3. The settlement, release, compounding, compromise, cancellation, rearrangement, or consolidation of any of the Obligations;

9.4. Any assignment, endorsement, or transfer, in whole or in part, of the Obligations, whether made with or without notice to or the consent of Guarantor;

9.5. Any action giving rise to any defenses, set-offs, or counterclaims that may be available to Borrower or to any third party;

9.6. Any neglect, delay, omission, failure, or refusal of Lender to take or prosecute any action with respect to any lien, security interest, or other collateral provided by the Loan Documents;

9.7. The collection of or other liquidation of any claims Lender may have in respect to the Obligations;

9.8. The granting of indulgences, forbearances, compromises, extensions, or adjustments in respect to any covenant or agreement under the Loan Documents;

9.9. The release from liability of any Guarantor and/or any additional parties who may guarantee completion of construction of the Improvements, or payment of the Obligations or any portion of the Obligations;

9.10. The release, surrender, exchange, or compromise of any lien, security, or collateral held by Lender as security for the Obligations;

9.11. The release or compromise of any lien or security held by Lender as security for the liability of any person who is guarantying the Obligations; or

9.12. Taking any action that might arise by the operation of law or any other any cause, whether similar or dissimilar to the foregoing.

10. CUMULATIVE REMEDIES.

Guarantor agrees that all rights and remedies that this Guaranty affords to Lender are separate and cumulative and may be pursued separately, successively, or concurrently, as Lender deems advisable. In addition, all such rights and remedies are nonexclusive and shall in no way limit or prejudice Lender's ability to pursue any other legal or equitable rights or remedies that may be available under the Loan Documents or otherwise. Without limiting the generality of the foregoing, Guarantor agrees that in any action by Lender by reason of the Obligations, Lender at its election may proceed (a) against Guarantor together with Borrower, (b) against Guarantor and Borrower individually, or (c) against one or more Guarantor only without having commenced any action against or having obtained any judgment against Borrower.

11. WAIVERS BY GUARANTOR.

11.1. Guarantor waives to the extent permissible by law for the benefit of Lender, and its participants, endorsers, successors, and assigns:

11.1.1. Notice of acceptance of this Guaranty and of creation of the Obligations;

11.1.2. Presentment, notice of nonpayment, and demand for payment of the Obligations, and notice of default (except as specifically provided for in this Guaranty) or delinquency or acceleration of the Obligations, Guarantor thereby assuming responsibility for being and keeping itself informed of the financial condition of Borrower and of all other circumstances bearing on the risk of nonpayment of the Obligations that diligent inquiry would reveal, and agreeing that (i) Lender shall have no duty to advise Guarantor of information known to it regarding such condition or any such circumstance, and (ii) Lender has made no representation to Guarantor as to any such conditions or circumstances;

11.1.3. Protest, notice of protest, and notice of dishonor or default (except as specifically provided for in this Guaranty) to Guarantor or to any other party with respect to any of the Obligations;

11.1.4. All other notices to which Guarantor might otherwise be entitled (except for any notice of default specifically provided for in this Guaranty);

11.1.5. The right to receive demand for payment or performance under this Guaranty except as provided in Section _ _[*e.g., 3*]_ _ of this Guaranty;

11.1.6. Any defense or circumstance (including, without limitation, disability, insolvency, lack of authority or

power, insanity, minority, death, or dissolution) that might otherwise constitute a legal or equitable discharge of Guarantor's liability under this Guaranty;

11.1.7. Any defense of Borrower to the Obligations;

11.1.8. Any rights to extension, composition, or otherwise under the Bankruptcy Code or any amendments thereof, or under any state or other federal statute;

11.1.9. The right to trial by jury in any litigation arising out of, relating to, or connected with this Guaranty, it being acknowledged by each Guarantor that each Guarantor makes this waiver of trial by jury knowingly and voluntarily and only after consultation with sophisticated legal counsel of Guarantor's choosing.

11.1.10. Any and all limitations on the right of Lender to obtain against Guarantor a judgment on this Guaranty under (1) California Code of Civil Procedure §§580a-580d, 726, or elsewhere under California law, or (2) the case of *Union Bank v Dorn* (1967) 254 CA2d 157, 61 CR 893, and the legal rules therein applied;

11.1.11. All rights or defenses that Guarantor may have as set forth in Division Three, Part 4, Title 13 of the California Civil Code;

11.1.12. Any and all defenses, including but not limited to Guarantor's defense of estoppel discussed in *Union Bank v Gradsky* (1968) 265 CA2d 40, 71 CR 64, based on foreclosure of all or any part of the real property security for the indebtedness of Borrower pursuant to the power of sale contained in the Deed of Trust as opposed to proceeding by way of judicial foreclosure. Guarantor waives all rights and defenses arising out of an election of remedies by the creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guaranteed obligation, has destroyed Guarantor's rights of subrogation and reimbursement against the principal by the operation of §580d of the Code of Civil Procedure or otherwise. Guarantor makes this waiver with full knowledge that if Lender elects to foreclose on all or any part of the real property security for the indebtedness of Borrower pursuant to the power of sale contained in the Deed of Trust as opposed to proceeding by way of judicial foreclosure, and the proceeds from the foreclosure sale are insufficient to satisfy in full the indebtedness of Borrower, Guarantor will be obligated to satisfy such deficiency and any action by Guarantor against Borrower to obtain reimbursement of the amount paid by Guarantor, whether brought pursuant to the legal theory of a guarantor's right to reimbursement or subrogation to the rights of Lender, or under any other legal theory, may be barred as a result of Lender's election of remedies in view of the provisions of California Code of Civil Procedure §580d;

11.1.13. All rights and defenses that the Guarantor may have because the Borrower's debt is secured by real property. This means, among other things: (i) Lender may collect from the Guarantor without first foreclosing on any real or personal property collateral pledged by the Borrower. (ii) If Lender forecloses on any real property collateral pledged by the Borrower: (A) the amount of debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price, (B) Lender may collect from the Guarantor even if Lender, by foreclosing on the real property collateral, has destroyed any right the Guarantor may have to collect from Borrower. This is an unconditional and irrevocable waiver of any rights and defenses the Guarantor may have because Borrower's debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based on §580a, §580b, §580d, or §726 of the Code of Civil Procedure.

11.1.14. Any and all demands, actions, defenses, defaults, claims, breaches, causes of action, obligations, damages, and/or liabilities of any nature whatsoever existing as of the date of this Guaranty that Guarantor has or may have against Lender arising from or out of the Loan, the Loan Documents, and the real property described on *Exhibit "A"* attached to the Deed of Trust.

11.1.15. Any right Guarantor has or may have under §580a of the Code of Civil Procedure purporting to limit the amount of any judgment that might be recoverable following a trustee's sale under the Deed of Trust.

11.2. It is expressly agreed that Guarantor shall remain liable on this Guaranty regardless of whether Borrower is held to be not liable on the Obligations and regardless of whether all or any portion of the Obligations are "non-recourse" or "limited recourse." It is agreed between Guarantor and Lender that the foregoing waivers are of the essence of the Loan transaction and that, but for this Guaranty and such waivers, Lender would decline to make the Loan.

11.3. Guarantor acknowledges that it is responsible to perform the Guarantor Obligations as provided in this Guaranty notwithstanding that the Borrower's liability for these Obligations may be diminished or eliminated by operation of bankruptcy or creditor's rights laws or otherwise. If Borrower, before or after payment of all sums covered by this Guaranty, should take advantage of any bankruptcy or debtor relief law by which Lender is required to return any portion of the sums covered by this Guaranty, including, without limitation, as a result of any determination that a fraudulent conveyance or preference exists, this Guaranty shall remain in full force and effect as to such sums (and any other sums unpaid under this Guaranty) on the terms set forth in this Guaranty until Lender has been repaid all such sums, and Guarantor shall otherwise render full performance to Lender.

11.4. Guarantor authorizes Lender, without notice to Guarantor, to apply all payments and credits received from Borrower or from Guarantor or realized from any security in such manner and in such priority, as Lender in its sole judgment shall see fit, to the indebtedness, obligations, and undertakings that are the subject of this Guaranty.

12. WAIVER AND RELEASE OF SUBROGATION AND PARTICIPATION.

Unless and until Completion of Construction (as defined in the Loan Agreement) of the Improvements has occurred and all of the Guarantor Obligations have been fully satisfied, Guarantor shall have no rights of reimbursement, indemnity, or contribution from the Borrower or any other rights by law, equity statute, or contract that would give rise to a creditor-debt or relationship between Guarantor and the Borrower. Guarantor shall have no right of subrogation in or under the Loan Documents. Guarantor shall have no right to participate in any way in any of the collateral that is conveyed under the Loan Documents as security for the Obligations. Guarantor explicitly waives and releases any of the above-described rights of subrogation, reimbursement, indemnity, contribution, participation, and any right to require the marshaling of Borrower's assets under any circumstances.

13. SUBORDINATION.

Any obligation or debt of Borrower now or hereafter held by Guarantor is subordinated to the Obligations and Guarantor shall not enforce or collect any such indebtedness from Borrower. Nevertheless, on request by Lender, Guarantor shall collect, enforce, and receive such indebtedness of Borrower to Guarantor. Any sums collected at Lender's request or collected in contravention of the prohibition set forth in this Guaranty shall be held by Guarantor as trustee for Lender and shall be paid over to Lender on account of the Obligations; provided, however, such payments shall not impair, reduce, or affect in any manner the liability of Guarantor under the other provisions of this Guaranty. Guarantor agrees to indemnify and hold Lender harmless from and against any and all loss, cost, damage, liability, or expense (including without limitation reasonable attorney fees and costs) incurred by Lender incident to or in connection with any allegation or finding that the delivery of this Guaranty is a "preference" under 11 USC §547.

14. REPRESENTATIONS AND WARRANTIES.

Guarantor represents and warrants to Lender that:

14.1. Guarantor now has no defense whatever to any action, suit, or proceeding whatsoever that may be instituted on this Guaranty;

14.2. No other agreement or special condition exists between Guarantor and Lender regarding the liability of Guarantor under this Guaranty;

14.3. This Guaranty constitutes a valid and binding obligation of Guarantor, enforceable in accordance with its terms;

14.4. Guarantor has received, or will receive, direct or indirect benefit from the making of the Loan to Borrower;

14.5. The execution, delivery, and performance of this Guaranty do not and will not require the consent or approval of any governmental body or other regulatory authority and are not in contravention of, or in conflict with, any law or regulation;

14.6. The execution and delivery of this Guaranty are not, and the performance of this Guaranty will not be, in contravention of, or in conflict with, any agreement, indenture, or undertaking to which Guarantor is a party or by which it or any of its properties is or may be bound or affected and does not, and will not, cause any security interest, lien, or other encumbrance to be created or imposed on any such property;

14.7. There is no litigation or other proceeding pending or, to the best knowledge of Guarantor, threatened against, or affecting, it or its properties that, if determined adversely, would have a material adverse affect on the financial condition, properties, or operations of Guarantor; and Guarantor is not in default with respect to any order, writ, injunction, decree, or demand of any court or other governmental or regulatory authority; and

14.8. The most recent financial statements of Guarantor previously delivered to Lender are true and correct in all respects, have been prepared in accordance with generally accepted accounting principles consistently applied, and fairly present the financial condition of Guarantor as of the respective dates thereof, and no material adverse change has occurred in the financial condition of Guarantor since the respective dates thereof.

15. FINANCIAL STATEMENTS.

Guarantor agrees to deliver to Lender a copy of Guarantor's annual financial statement certified by Guarantor to be true and correct. While this Guaranty is in effect, such statements shall be delivered to Lender no later than _ _[*e.g., 120*]_ _ days after the end of each calendar year of Guarantor.

16. JOINT AND SEVERAL LIABILITY.

The term "Guarantor" as used in this Guaranty shall refer individually and collectively to all signers of this Guaranty. Each undertaking contained in this Guaranty shall be the joint and several undertaking of each signer of this Guaranty, and it is specifically agreed that Lender may enforce the provisions of this Guaranty with respect to one or more of such signers without seeking to enforce the same as to all or any such signers. Guarantor waives any requirement of joinder of all or any other of the parties to this Guaranty in any suit or proceeding to enforce the provisions of it.

17. STRICT PERFORMANCE; WAIVERS.

No failure, delay, or omission by Lender to exercise any of the rights, powers, remedies, and privileges under this Guaranty shall be deemed a waiver thereof and every such right, power, remedy, and privilege may be exercised repeatedly. No notice to or demand on Guarantor shall be deemed to be a waiver of the right of Lender to take further action without notice or demand as provided in this Guaranty. In no event shall any modification or waiver of the provisions of this Guaranty be effective unless in writing executed by Lender and Guarantor. Any waiver granted shall be applicable only in the specific instance for which it is given. Failure of Lender to insist on strict performance or observance of any of the terms, provisions, and covenants of this Guaranty or to exercise any right contained in this Guaranty shall not be construed as a waiver or relinquishment of the right to demand strict performance at another time. Receipt by Lender of any partial payment or partial performance of the Obligations or of the Guarantor Obligations shall not be deemed a waiver of the breach of any provision of this Guaranty or of any of the Loan Documents.

18. CAPTIONS.

The captions appearing in this Guaranty are used for reference only and shall not be construed as limiting anything set forth in this Guaranty.

19. SEVERABILITY.

The invalidity or unenforceability of any provision of this Guaranty shall not affect the other provisions of it, and this Guaranty shall be construed as if the invalid or unenforceable provision had never been a part of this Guaranty.

20. GOVERNING LAW.

All questions with respect to the construction of this Guaranty and the rights and liabilities of the parties to this Guaranty shall be determined in accordance with the applicable provisions of the internal laws of the State

of California without regard to the principles of conflicts of laws.

21. ASSIGNMENT; DELEGATION; BINDING EFFECT.

This Guaranty is assignable and transferable by Lender. Each reference in this Guaranty to Lender shall be deemed to include its successors and assigns, in whose favor the rights and privileges of this Guaranty shall also run. If Lender elects to sell participations in the Loan and the Loan Documents, including this Guaranty, or otherwise assigns this Guaranty, Lender may forward to each participant and prospective participants or other assignee all documents and information relating to this Guaranty or to Guarantor, whether furnished by Borrower or Guarantor or otherwise. The duties and obligations of Guarantor may not be delegated or transferred by Guarantor without the prior written consent of Lender. The duties and obligations of Guarantor shall bind Guarantor's heirs, personal representatives, executors, successors, and assigns.

22. COUNTERPARTS.

This Guaranty may be executed in one or more counterparts, each of which shall for all purposes be deemed an original, and all of such counterparts shall together constitute but one and the same document.

23. MULTIPLE GUARANTORS.

It is specifically agreed that the liability of each party signing this Guaranty shall attach fully at the time of such party's execution of the Guaranty, without regard to the failure of any other party to execute this Guaranty.

24. TERMINATION; REINSTATEMENT; LIMITATION.

24.1. Subject to Section _ _[*e.g., 24.2*]_ _ below, Guarantor's obligations under this Guaranty shall terminate, and this Guaranty shall be released, on the Completion of Construction (as defined in the Loan Agreement) of the Improvements and full performance of the Guarantor Obligations as provided in this Guaranty.

24.2. This Guaranty shall remain in full force and effect and continue to be effective should any petition be filed by or against Borrower under the Bankruptcy Code, as at any time amended, for liquidation or reorganization, or should Borrower become insolvent or make an assignment for the benefit of creditors or a receiver or trustee be appointed for all or any significant part of Borrower's assets, and this Guaranty shall continue to be effective or be reinstated, as the case may be, if at any time payment of the Obligations, or any part thereof, is, pursuant to applicable law, rescinded or reduced in amount, or must otherwise be restored or returned by Lender, whether as a "preferential transfer," "voidable preference," "fraudulent conveyance," or otherwise, as if the portion of such payment rescinded, reduced, restored, or returned had never been made.

25. NOTICES.

All notices demand, waivers and other communications (Notices) required or permitted to be given under this Guaranty shall be in writing and (a) delivered personally; (b) delivered by a nationally recognized overnight delivery service; or (c) by facsimile transmission with a "hard" copy delivered within the next _ _[*e.g., 2*]_ _ business days addressed to the appropriate party as follows:

Lender: _____
_____
_____
_____
Attn: _____
Facsimile No. (___) ___-____

and to

_____
_____
_____
Attn: _____

Facsimile No. (___) ___-____

Guarantor _____
_____
_____
_____
Facsimile No. (___) ___-___

Notices shall be deemed given on (a) delivery, if delivered in person or by facsimile transmission with receipt of confirmation received or (b) _ _[*e.g., 1*]_ _ business day after having deposited for overnight delivery with any nationally recognized overnight courier service. Notice of any changes of address or of the person to whom are to be sent shall be given in the manner set forth in this Section. All Notices must include the application numbers and mortgage numbers specified in this Guaranty.

26. JURISDICTION.

Guarantor consents to the nonexclusive personal jurisdiction of the federal and state courts located in California in any and all actions between the Guarantor and Lender arising under or in connection with this Guaranty, the Loan, or any of the Loan Documents.

IN WITNESS WHEREOF, Guarantor has duly executed this Guaranty the day and year first above written.

GUARANTOR: **Date: _ _ _ _ _ _**
__[*Signature*]__
_ _[*Typed name*]_ _

Comment: For a detailed discussion of completion guaranties, see §§9.30A-9.30L. On guaranties in general, see chap 6. On enforceability of waiver of jury trials, see comment to §§3.103, 4.58, 4.115.

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Securitized Commercial Mortgage Loans

Maura B. O'Connor
James Bryce Clark

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§10.1 I. SECURITIZATION AND CONDUIT LOANS; COMPARED TO TRADITIONAL LENDING

Securitization is a method of obtaining investment capital by packaging a group of similar financial assets, such as mortgage loans, and then selling interests in the entire pool to investors in the capital markets. This approach sometimes is called "conduit" lending because the role of originating lenders—the party with whom the borrower typically interacts—is converted from a long-term business relationship into a front office, or conduit, where the financial asset of a loan is created but then quickly transferred to other holders. The investment vehicles are known as commercial mortgage-backed securities. (See background discussion in §1.90.) This type of financing became popular over the last decade because it gave borrowers access to a wider range of funding sources than traditional real estate lending institutions such as banks and insurance companies. However, even real estate loans originated or branded by a well-known bank are often quickly transferred over to a securitizing secondary market investor or arranger. These newer funding sources often have lower overhead costs and different economic goals and expectations; they have also proved to have significantly different regulatory implications and risk orientation.

Securitization, as a capital markets strategy, generally brings new money into the lending market by making it possible for groups of investors to aggregate their loan funds to buy larger pools of more diverse obligations. If 1,000 lenders each make one consumer loan, some percentage will risk a complete loss due to default or documentation flaws. Instead, by pooling their funds and the investments together, and by each buying a fractional share in the entire loan portfolio, lenders theoretically can diversify their investment. If the loans in the portfolio are accurately reviewed and described, this approach spread their risk of loss. The "arrangers" who assemble and resell these aggregate portfolios have carved out their own rewarding financial niche. The development of more sophisticated data-handling capabilities and loss-prediction models have permitted arrangers to pool and predict the aggregate return from portfolios of commercial loans (and other pooled assets) more accurately. When those capabilities are used correctly, and the loss models are accurate, this can result in more efficient loan pricing. Of course, when administered badly, these seeming efficiencies can cause both loans and the wealth that results from them to fail in large volumes.

Over the last 15 years, liberalization of securities laws and banking regulations expanded the eligibility rules for persons investing in such securities and decreased the cost and delay associated with offering those investments. The structuring of lending transactions to create "special-purpose entities" and "bankruptcy-remote entities" (see §§10.14-10.15) has been developing for several decades and continues to be refined by case law and adopted in an ever-widening range of transactions. The April 2009 bankruptcy of General Growth Properties, which included 166 supposedly bankruptcy-remote entities, will undoubtedly lead to further evolution in this area.

Encouraged by the savings in administration costs, and the increased access to the capital markets as a relatively low-cost source of funds, lenders gradually applied this technique to more diverse pools of unique financial assets. Increasingly, a wide variety of financial assets beyond real estate loans have been packaged by securitization methods. These methods are new enough that only recently have they been stress-tested in a significant economic downturn. The increased diffusion of responsibility among multiple lending and investing parties in a securitization also risks diffusing responsibility and oversight for failures of the system. Many of the loosened regulatory and risk management practices that permitted these innovations are likely to be reassessed for safety and abuse risks, as the extent of poor loan administration becomes more clear.

Conduit financing is summarized and briefly explained in the context of other types of real property secured financing in §§1.18, 1.33, 1.90-1.107. It is more developed in the sections that follow in this chapter, which has sample form clauses for conduit loan (*i.e.,* lender-borrower) documents in §§10.28-10.33.

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§10.2 A. Differing Economic and Regulatory Environments for Securitized Loans

A traditional lender lends money from its own balance sheet. Banks deploy funds generated from repayments of other loans, consumer deposits, and the like; insurance companies use funds generated from the policies they sell. These traditional lenders focus more on holding a loan, as an investment, once it is originated. The lenders' primary concern is applying their own credit criteria to verify that borrowers and their collateral meet certain quality standards and are likely to pay back the borrowed money.

On the other hand, a securitizing lender draws upon the capital markets to get *someone else's* money to lend to the borrower. Once a loan is originated, this newer breed of lender "pools" or bundles it with other similar loans and transfers it to an arranger, such as an investment bank's mortgage capital desk, that sells off the income generated by the pool in pieces to investors in the capital markets. The arranger, for a share of the profit, essentially acts as the representative for the true lenders, who are the investors, by designing and creating the pool of assets, and managing the issuance of securities by the special-purpose entity created to hold them. The term "securitization" refers to the conversion of the pool of loans into securities, by redividing the income from the pooled loans into new (and usually more abstract) securities, which are then sold to the investors. The securitizing lender is foremost a seller, whose primary goals are to create loans, to conform them to criteria optimized for resale to investors, and then to sell them off, leaving collection and enforcement to another party. The differing backgrounds and experience of the securitized loan's administrator (as arranger and then servicer) and ultimate owners (investors in pooled securities) may affect their expertise, as well as their strategy. Thus, a lender who specializes in portfolios of specific types of real estate loans may have acute insight into the nature and risks of specific collateral.

The distinct requirements that securitization imposes on loans derive mostly from the different needs and economic roles of the ultimate investors on whom a lender will lay off his risks. Traditional lenders think, "Which other banks or mutual funds will buy participations in this, and after closing, can I explain it to the regulators in our next audit?" Originators think, "Will this fit within the criteria for the next pool we're selling off, and can I meet the rating agency criteria before closing?"

Of course, the "hold" and "sell" models are two points on a continuum, not absolute rules. Conventional lenders do not always hold the loans they originate. Even when they do, their internal credit criteria are heavily influenced by outsiders (such as regulators and equity investors) as well as third parties on whom they may wish to lay off some credit risk (such as mortgage insurers and loan participants). Similarly, even in strong economic conditions, securitized lenders may not always be able to sell. Most securitization deals leave some credit risk with the originator (through representations, warranties, and repurchase obligations) for loans that default or do not perform as expected. Therefore, bad loans may end up back on the originator's balance sheet.

NOTE: Historically, the buyers of "B" junior tranches—the more speculative portion of a mortgage pool's repayments, in which most of the risk and volatility sits—frequently held their "B piece" interests for future appreciation. In fact, often these holders of "B piece" interests were the original lenders, retaining the riskier (less saleable) bits of the pool by necessity, after selling off the more reliable "A" tranches. In the last few years, however, even these "B pieces" sometimes have been recomposed into new securities and sold off as "collateralized debt obligations" (see §10.26A).

Some arrangers believe that there is little practical difference between the economic behaviors and assessment of risk of securitized loan servicers and traditional real estate lenders. As different loan "products" compete in the markets, the terms and styles of the various approaches may converge: a traditional bank or insurance company often lays off its commercial loans to a third party stranger as quickly as a securitization pool sells its composite securities to investors. See Thangavelu, *Securitization's Evolution Has Changed Financing,* Mortgage Line (Oct. 27, 2005).

Nevertheless, the hold-versus-sell dichotomy helps explain the distinct documentation, structure, and risk-taking behaviors that distinguish the new world of securitized lending from the old world of conventional loans. The imperative that each loan must be pooled and sold off into a specific capital market, with different regulatory requirements and

different investors than conventional lenders face, exerts an irresistible force on everything that a securitizing lender does.

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§10.3 1. Unbundling the Lenders' Role

Securitization unbundles the traditional lender's role into separate parts, typically including:

- An "originator," who finds the borrower, does the credit analysis, and funds the original loan proceeds;
- A separate "sponsor" or "arranger," who finds the investors and structures the pooled assets into securities;
- "Investors," who supply the funds by purchasing the securities;
- A "trustee," or other investors' representative, the owner of the pool, who in turn distributes periodic payments to the investors; and
- The "servicer," who assumes the traditional lender's role remaining after the loan has been closed and funded. There are often several servicers designated—one for operations in the ordinary course of business (the "master servicer") and others to service the loan only after a borrower default (typically called "special servicers").

Several different variations of the lender structure (as outlined above) exist, depending on the precise structure dictated by the needs of the transaction and the preferences of the arranger. See generally Fabozzi & Ramsey, Collateralized Mortgage Obligations: Structures and Analysis (3d ed 1999).

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§10.4 2. Lower Cost of Funds and Lower Quality Markets; Emergence and Difficulties of Subprime Loans

Historically, the interest rate pricing of securitized real estate loans has tended to be significantly lower than that of traditional loans, for two reasons. First, capital markets are large and efficient, which tends to result in more price competition than the oligopoly of traditional institutional lending. Second, investors in securitized pools are not subject to the substantial reserves, capital adequacy regulations, and regulatory compliance costs required of most traditional lenders. In practice, the savings from these differences are often great enough that securitizing lenders can underbid traditional lenders, offering significantly lower rates. Thus far, except for occasional hiccups in the capital markets, this has generally been true even *after* factoring in the higher transactional overhead associated with more complicated documentation, securities law compliance, and significant fees charged by sponsors and servicers.

For a discussion of the advantages of conduit financing, see §1.91.

However, this lower cost basis for lending also has made possible a range of credit transactions that may not have been feasible in conventional institutional lending. Most notably, it has opened up inferior-quality credit opportunities, with results sometimes empowering and sometimes dangerous.

The term "subprime mortgages" generally refers to residential mortgage loans made to borrowers with substandard credit for the transaction in question (due to, among other things, insufficient income documentation, past credit problems, high debt levels, or an unusually high loan-to-value ratio). See, *e.g., Atlas v Accredited Home Lenders Holding Co.* (SD Cal 2008) 556 F Supp 2d 1142. The borrower default rates on such loans generally are correspondingly higher. Arguably, securitization technology makes this type of transaction more viable, as the lower cost of funds and inexpensive loan administration (1) permit new breeds of less-capitalized lenders to enter the mortgage market and (2) allow lenders to price and offer loans with a higher risk of nonpayment.

The subprime market has existed since the 1980s, but its real growth as a significant sector began in the mid-1990s, when fewer than 5 percent of mortgage loan originations were classified as subprime. By 2005 that share rose to about 20 percent. See Testimony of S. Braunstein, Director, Division of Consumer & Community Affairs—Federal Reserve Board, before Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives (Mar. 27, 2007) (which can be found on the Federal Reserve website listed in the Directory).

Originators, and sometimes servicers, in the subprime market often may be a rarified breed of entity, far evolved from a conventional commercial bank. Their own equity stake in the loans is highly transitory, as each batch of loans is originated, flipped into a securitization pool, and offloaded to the pool's trustee. That thinly capitalized balance sheet may mean that little assets stand behind an originator's promise to repurchase nonperforming loans from a pool trustee. Indeed, a number of subprime originators recently have neared or fallen into bankruptcy. See, *e.g., Miller v Greenwich Capital Fin. Prods., Inc. (In re American Bus. Fin. Servs., Inc.)* (Bankr Del 2007) 362 BR 149. Of course, when a riskier group of loan assets and a less well-financed group of new lenders are exposed to a financial downturn, the incidence of defaults and failures will rise. This reduces the willingness of investors to purchase the progressively riskier securitized bonds (the derivative payment securities issued by the pools). In a traditional banking context, the loss of confidence caused by a string of bad bank investments leads eventually to a "run on the bank." In the securitization world, the investors refuse to purchase the less attractive securitization bonds, which, in the worst cases, can lead to failure of capitalization of the lender, and possibly, the failure of the lender. As of mid-2008, some such failures began to occur; the availability of subprime and lower-cost, higher-risk loans began to dry up in response to the reduced availability of cheap capital.

The widely publicized problems of subprime residential mortgages and falling home price markets, along with the more general economic downturn in 2008, have also caused investors to question both the performance of commercial-property-backed mortgage securities, and the reliability of rating agency assurances on those bonds. This has led to the ongoing credit "crunch" or "freeze," since due to the unavailability of willing capital, such loans have become less available regardless of the health and value of the underlying real estate collateral.

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§10.5 3. Different Regulatory Incentives and Requirements

In return for their unique access to consumer funds (see §10.2) and certain governmental liquidity sources, traditional lenders are subject to relatively heavy regulation. For example, bank regulators carefully scrutinize loan portfolios for credit quality, adequate reserves against loss, geographic and industry concentration, and interest rate sensitivity. The results of these examinations are largely kept between the government and the banks, to give internal guidance to the institution's fiscal management and to detect any problems that might later require a bailout. The limits imposed by regulators on a traditional bank's loan portfolio can affect the substantive terms of a loan as well as the permissible credit profiles of borrowers—a regulator may dictate that the lender may only carry so many undercollateralized loans, so many loans in the Southeastern software industry, and so on—in order to protect the safety and soundness of the regulated institutions. Regulatory scrutiny of the loan quality, diversification, and rate sensitivity of a bank or insurance company's loan portfolio can be rigorous, but also generally is conducted behind closed doors.

On the other hand, transactions in securitized instruments are governed by the securities laws. The sponsors must produce detailed disclosure documents for investors (*e.g.,* "private placement memoranda" or "offering circulars") that describe the pooled loans. The production of these documents is expensive, due to the materiality, clarity, and diligence standards required by the laws governing the securities markets. Under this regime of law, credit risks are not so much *prohibited,* as *evaluated* for quantifiability, uniformity, and acceptability to the marketplace. The arrangers of a securitized offering induce third parties to purchase interests in the pooled loans by relying on their disclosure documents, without independent examination of the underlying obligations. (In contrast, a traditional lender seeking participants to purchase interests in a loan—*i.e.,* other investors on whom to lay off part of the risk—usually requires that the purchasers make their own *independent* evaluation of the documentation, the borrower, and the collateral.) As has widely been noted in retrospect, the antifraud constraints of securities laws did not impose underwriting rigor on many of these lightly regulated or unregulated financial entities.

Still, because of the possibility of securities law causes of action (see *Atlas v Accredited Home Lenders Holding Co.* (SD Cal 2008) 556 F Supp 2d 1142), theoretically, the consequences of inaccurate statements by securitizing parties about the loans they handle are greater than in traditional lending. The securitizing lender's need for disclosable uniformity creates some pressure to use standardized documentation and objective, formulaic credit-scoring methods. See §§1.92, 10.6. Uniformly evaluated and documented loans are easier to combine into a pool whose aggregate economic characteristics can be accurately described, and whose future economic performance can be more readily predicted.

The holders of securitized debt certificates from loan pools can and do sue the issuers and arrangers of those securities for lax credit standards or loan diligence, if that laxity leads to loan quality below the pool's stated credit standards and a decline in the pool's value results. See, *e.g.*, *LaSalle Bank Nat'l Ass'n v Nomura Asset Capital Corp.* (2d Cir 2005) 424 F3d 195 (trustee for securitized certificate holders stated valid claim against originator for failure of pooled mortgage to meet pool's stated minimum loan-to-value ratio); *In re National Century Fin. Enters., Inc.* (SD Ohio 2007) 541 F Supp 2d 986 (certificate holders stated valid claims against arranger under federal and state securities laws, for insufficient disclosure and due diligence in originating lender's lax loan practices); *Teamsters Local 445 Freight Div. Fund v Bombardier Capital Mortgage Securitization Corp.* (SD NY, Sep. 6, 2005, No. 05 Civ 1898) 2005 US Dist Lexis 19506 (dicta suggesting valid claim based on reckless loan underwriting).

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§10.6 4. Different Underwriting and Documentation Criteria

Traditional lenders review the collateral and any other credit sources (such as guarantors) in order to create a credit analysis, which amounts to a financial model of the likelihood of repayment. This reflects the typical primary concern of such lenders, which is to hold the loan through maturity and be repaid. If other lenders share in the credit as participants or members of a syndicate, they are generally required to conduct their own separate credit analysis, so that each lender relies on its own conclusions regarding repayment risks. Each lender is free to use its own criteria. Particular lenders often develop relationships and expertise in specific regions or types of property, which may give them competitive advantages such as superior credit analysis or relationships with loan prospects.

On the other hand, originators of loans to be securitized are principally concerned with ensuring that individual loans fall within the parameters for the anticipated loan pool to be packaged for resale. Once a group of similar loans is pooled, the payment rights forming that pool are fashioned into securities and investments typically offered for purchase to other types of investors. In order to agree on a price and predict their return, those investors depend on disclosures that characterize the common (or minimum) credit and asset quality, and deal structure characteristics, of the entire pool of similar loans. That demand for clear disclosure and predictable pricing imposes a great deal of uniformity on the loans being prepared for securitization. See §10.5. In order to take advantage of those pools (by selling the loans into them), the originating lender must ensure that each loan fits a specific profile of structure, terms, and collateral assets.

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§10.7 a. Impact of Rating Agency Criteria

In a decentralized chain of financial loan transactions, pieces of the loans (like payment streams and tranches) and pieces of the legal duties (like servicing or collection) are carved up and distributed to multiple parties. This means that there are rarely experts with a central vantage point: no one is in a continuing position to make subjective evaluations or carefully watch the organic behavior or quality of a credit over time. The old "health check calls" of the banks of yore (when the floor financer dropped in on the business to see how things were going or the long-time banker called to evaluate the creditworthiness of a would-be borrower) are gone from many parts of the lending world. Often, rote financial covenant tests and credit ratings have taken the place of discretion. Thus, rating agencies have moved from supporting players to the central role of lending credit analysis and assuring the soundness of loan pools. This puts great pressure on the major rating agencies, on whose evaluations a securitization pool's value and validity may rely.

Many of the parameters of a securitized loan are based on rating-agency criteria and what the sponsor thinks the investor market will find acceptable. Rating agencies such as Standard & Poor's Ratings Group and Moody's Investors Service, Inc. rate the loan pools, generally for a fixed fee, based on standardized contracting, structuring, and collateral criteria. Their rating affects the marketability of the securities to investors and the rate of return that investors will require. In other words, the higher the rating of the securities, the more investors will be willing to pay for them (*i.e.,* the lower the rate of acceptable return). In a sense, the rating agencies and their set criteria take the place of in-house credit analysts and their customized review. For additional discussion of the role of rating agencies, see §1.93.

The rating agencies impose on securitized loans many of the same paper requirements that traditional lenders employ, such as relatively recent and favorable Phase I environmental reports and noninvasive structural reports, and an opinion of counsel as to the validity of the lending documentations and their conformance to law. See, *e.g.,* §§1.11, 1.65, 1.69-1.70, 8.27. In both contexts, many issues are resolved based on what a prudent lender would do. However, there may be subtle differences in approach based on the regulatory regime that influences the lenders in question, and the degree to which there has, or has not been, any hands-on supervision of the credit analysis and origination transaction.

Just as a traditional loan's appraisal requirement is influenced by the minimum standards of the lender's regulators (see §§1.17, 1.74), a securitizing lender may be responding to the specific requirement or "guideline" of a given rating agency. While both may have closing requirements that address the timeliness or certification standards for an appraisal, the rating agency's requirements may differ from those of a bank regulator. A failure to meet one of those differing "guidelines" might go undetected until, after a loan closes, the lender attempts to qualify it for inclusion in a securitization pool. At that point, if the sponsor rejects the loan, counsel to the lender is going to have an annoyed lender as well as a borrower with little incentive to help solve the problem. Due to that risk, well-written securitizable loan documents generally include fairly broad "further assurances" undertakings, permitting the trustee/servicer to demand various types of cooperation from the borrower when assigning the loan to a pool. See §10.8. Inevitably, disputes over broken securitizations, and the substandard loans that may be included in them, increasingly are landing at the doorstep of the rating agencies.

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§10.8 b. Further Assurances and Other Risk Controls

"Further assurances" undertakings require the borrower to take reasonable additional steps to assist in qualifying the loan for inclusion in a pool after closing. See form clauses in §10.28 for an example of the expanded "secondary market" undertakings often sought; see also §10.24. These clauses typically are required in most securitized loans.

Generally, borrowers are likely to find more flexibility in credit criteria from traditional lenders than from securitizing lenders. A traditional lender may be better able to accommodate a loan with unusual risks, because it generally justifies its risk exposures to its regulators on an aggregate basis, over its entire loan portfolio. On the other hand, securitizing lenders must be able to make uniform statements (in their investor disclosure documents) that are true for every loan in the pool.

For example, in dealing with zoning and use restrictions in a pool of mortgage loans, securitizing lenders may need greater assurance that each loan is in "conformance with law" in order to validate the disclosure statements made to investors. As a result, in their due diligence process, such lenders may be more likely to require a review of certificates of occupancy, obtain title insurance coverage when available, and seek comfort letters from the local zoning authority. A discretionary waiver or substitute assurance that a traditional lender might find acceptable might, in a securitized loan, raise questions whether disclosures about the loan pool to investors misrepresent the quality of the loans. Other legal and financial constraints may also severely constrain a pool servicer's workout options. See §§10.16A-10.16B.

Similarly, a securitizing lender may be less comfortable with the title ambiguities often presented by older property. For example, street access to a parcel sometimes depends on poorly documented ingress/egress easements. In such a case, a traditional lender might use an inspection or survey to become comfortable with the risk, combined with informal discussions with the owner of the relevant adjoining property. The fiduciary duties to investors and increased disclosure burdens imposed on securitizing lenders might not permit or encourage the same flexibility.

One trade-off for that flexibility of traditional lenders is speed. In practice, most of the better originators and sponsors of securitized loans are fairly specialized and efficient. Their use of standardized criteria and their refusal to negotiate many of the terms in their mortgages enable them to credit-score, document, and fund proposed loans quickly. The relatively low barriers of entry in the loan securitization marketplace tend to keep the pressure on securitizing lenders to compete vigorously both on price and speed of execution.

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§10.9 B. Players and Goals During Repayment Life of Securitized Loan

The special character of securitized loans continues—in fact, it generally becomes more apparent—after the loan is originated and funded and begins its life as a financial asset under administration. The life cycle of a securitized loan includes some distinct features as a result of the pooling and servicing arrangements made at its outset. To make the loan a freely transferable asset, so that repayment will continue uninterrupted regardless of future assignments of the loan (see §1.95), the originator engages a servicer to collect and monitor the loan. In this sense, after a securitized loan is funded, the servicer is the "replacement" for a traditional lender. This represents a further unbundling of the various functions that were traditionally performed by a single lender. See §10.3.

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§10.10 1. Discrete Monitoring and Administration Roles

After a loan has been funded and is in repayment, the traditional lender monitors its own funds, or those of a syndicate of lenders on whose behalf it acts. A relationship or account manager for the loan compares the borrower's actual reported results with the covenants in the loan documents (which, in turn, were based on projections at the time the loan was made and the operating history of the encumbered property). To some degree, the borrower expects to have any future conversations during the term of the loan about its terms and covenants with the same people who negotiated them.

In contrast, a securitizing lender delegates the task of collecting payments and monitoring any continuing covenants to a servicer, who will ultimately report to the loan-pool investors. See §10.9. The servicer manages the pool for the benefit of the investors, as a fee-based service, typically under a contract (often called a Pooling & Servicing Agreement) which makes the servicer responsible for receiving payments on each pooled mortgage, handling collections and foreclosures, preserving the collateral when necessary (*e.g.*, advancing money for tax payments or maintenance), and keeping the certificate holders advised of relevant pool data (typically through a trustee). *Chase Manhattan Mortgage Corp. v Advanta Corp.* (D Del, Sep. 8, 2005, No. 01-507) 2005 US Dist Lexis 19374. Due to this web of explicit duties, a servicer is less likely than a conventional lender to exercise independent judgment about what further actions to take concerning a loan. Securitized loans may also use somewhat narrower covenants that require less analysis and review. For example, a securitized loan may be more likely than a traditional loan to require audited financial reports from some types of borrower, so as to avoid the additional time and discretion needed by the servicer to interpret unaudited or incomplete financials.

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§10.11 2. Less Negotiation, More Formulas in Early-Stage Workouts

The differing economic expectations of traditional lenders and securitization investors may result in different behavior when a troubled loan requires a loan workout. The loan portfolios of a traditional lender are scrutinized—by regulators and the lender itself—for credit quality, adequate reserves against loss, geographic and industry concentration, and interest rate sensitivity, among other things, not only when loans are originated, but also as part of the lender's regular, periodic review of its portfolio. As a result, changes in an individual loan's performance or its overall portfolio performance may affect the lender's loan administration and enforcement decisions. For a discussion of problem loan workouts of traditional lenders, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 10 (4th ed Cal CEB 2009). The typical securitizing lender, on the other hand, may expect to have made the last credit decision it will ever make about each loan when it originates the credit. In either case, after a loan is sold off (whether by a traditional lender's complete assignment or a pooled securitization transaction), the future performance of the loan, and the specific borrower's fortunes, literally will be of no concern to the (former) lender.

A lender who expects to continue to hold a troubled loan would like the loan to recover and perform. Thus, when defaults loom, traditional lenders often may attempt to renegotiate terms that the borrower finds difficult to meet. Such lenders may adjust financial covenants, reschedule obligations, impose cash-management tools, or modify the loan's collateral. An individual lender's appetite for such adjustments may vary with the degree of discretion it is willing to exercise, its own assessment of the borrower's prospects, and its own financial circumstances. Most institutional lenders are evaluated in part on their loan portfolio quality, so they may have an interest in keeping loans in "performing" (nondefaulted) status. Traditional lenders may also have multiple institutional relationships, or future expectations of business, with their borrowers or their affiliates, which influence such lenders' negotiating decisions.

But the servicer or trustee for a securitized loan pool faces fewer relationship considerations and more constraints on its freedom of movement. As fiduciaries for the investors, the investors' representatives often have little discretion or reason to vary from whatever pre-set criteria have been established for loan performance and enforcement in the loan documents and the pooling and servicing agreement. Typical investors do not expect a continuing relationship with a particular borrower and thus also have little reason to bargain. A servicer or trustee that recommends or implements a workout strategy that "throws good money after bad" by extending a loan or waiving covenants risks unhappy investors or a breach of the pre-arranged servicing agreement. Thus there may be little incentive for the securitized loan's servicer to work out nonperforming debt.

In addition, in the more conservative structuring of a securitized loan, a number of the opening moves that might have been suggested in the workout of a traditional loan (such as dedicated reserves, tighter cash management, requiring that rents be deposited into lockboxes, overcollateralization, and isolation of the business activities of the leveraged assets by use of an SPE, discussed in §§1.96-1.101, 10.13-10.23) often have been imposed from the outset. Workouts with the investors' representative in a securitized loan pool are possible, but the investors may have little incentive to cooperate with a failing borrower.

The web of contractual relations and securities law disclosures among originator, servicer, and certificate holders can transform small workout disputes into complex ones. The originator's possible contingent repurchase or support obligations add an additional layer of complexity. In addition, a loan pool servicer may be prohibited, by covenants, accounting rules, or even tax law, from making certain types of "workout" amendments to a loan once it has been funded and placed in the pool. See §§10.15, 10.18-10.19.

The presence of multiple stakeholders inevitably complicates relationships. This is true even in traditional loans, when a syndicated "lender group" encounters interlender disputes regarding how quickly, or in which way, to proceed against the borrower. In the world of securitized loans these disputes may be quickly magnified. For one thing, the parties are often transitory and may have no ongoing commercial relationships to moderate choices of workout tactics. For another, there is a risk of mutual finger-pointing among a diffuse cloud of parties, no one of which may clearly hold the exclusive right to bargain during a workout. The confluence of contract and securities law in a securitized deal also arguably offers more opportunities for legal action. See, *e.g.*, *LaSalle Bank Nat'l Ass'n v Merrill Lynch Mortgage*

Lending, Inc. (SD NY, Aug. 13, 2007, No. 04 Civ 5452) 2007 US Dist Lexis 59301 (pool trustee sues lender for failure to repurchase failing loan in pool). In *LaSalle Bank*, the trustee demanded that the originator repurchase a loan simply because it had granted a few waivers of late payments in the first few months of a pooled loan. The trustee took the position that these short delinquencies and waivers, unremarkable from the originating lender's point of view, nevertheless disqualified the loan, and, since the waivers were not disclosed when the pool was assembled, constituted a breach of the initial warranties as well (particularly that the loan had met customary industry standards). The presence of these additional parties seems likely to continue to complicate real estate workout litigation in novel ways. See discussion in §10.26.

While a request for waiver or forbearance in a conventional loan context would not generally raise any alarms, in a securitized pool context such relatively mundane requests may trigger close examination of servicing contracts and disclosure documents and consultation with legal counsel.

PRACTICE TIP: Real estate workout counsel must do their diligence, and investigate more deeply the larger web of parties, contracts, disclosures, and guidelines that influence and constrain their securitized transaction. It is not uncommon for a mildly creative workout lawyer to find some options that the original parties fail to recognize.

With multiple "lenders" in a securitized loan, the opportunities for interlender disputes multiply. In the residential subprime market crash, recent threads of litigation started or threatened include:

- SPE trustees suing the originator and arranger/underwriters on behalf of the pool on theories of misleading disclosures or fraudulent conveyance);
- SPE trustees suing the servicers on behalf of the pool originator and arranger/underwriters claiming breach of contract;
- Shareholders of an originator suing that lender and its professionals (accountants, lawyers, underwriters, *etc.*) on theories of negligence, malpractice, accounting failures or failures to disclose;
- Insurers of the mortgage collateral suing the SPE and arranger alleging underwriting failure; and
- SPE investors suing the SPE trustee (and all others involved in the loans) for fiduciary duty oversight failures.

Sabry & Schopflocher, *The Subprime Mortgage Meltdown: Who, What, Where and Why… Investigations & Litigation,* PLI Corporate Law and Practice Series No. 15783 (Sept. 2007).

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/10 Securitized Commercial Mortgage Loans/§10.12 3. Securitizing Lenders' Troubled Assets and REO Property; What Happens After (or Instead of) Foreclosure

§10.12 3. Securitizing Lenders' Troubled Assets and REO Property; What Happens After (or Instead of) Foreclosure

Traditionally, institutional lenders worked out nonperforming loans on a "retail" basis, one at a time. A lender may attempt to work out an extension or modification of the loan, or a refinancing, or a consensual surrender of collateral in exchange for forgiveness of all or part of the loan balance. Failing such a solution, a defaulted real estate loan is usually resolved through a foreclosure and/or the borrower's bankruptcy, as a result of which the lender often must take title to its collateral as "REO" (real estate-owned) property and sell it to recover its losses. Foreclosure and bankruptcy remedies clear up competing claims to the property to some extent, which makes the property somewhat more marketable than the unique nonperforming loan would have been.

For traditional lenders, the foregoing process is generally guided and negotiated by counsel, based on the facts and circumstances of the individual loan and the idiosyncrasies of a particular state's real estate law. The costs and delay associated with that process reduce the net proceeds from the eventual liquidation of the collateral. Some traditional lenders do buy and sell interests in distressed loans, but this opportunity also involves substantial costs due to the delays inherent in custom negotiation and independent diligence.

Distressed securitized loans often are less likely to receive customized, "retail" workout attention, for several reasons. First, the loan pool is managed by a servicer or investors' representative with less discretion to settle, and little authority to spend legal fees for a complex resolution. As a result, distressed securitized loans may tend to be handled in "wholesale" fashion, with a stronger bias toward quick decisions and cutting losses. Second, because the interests in a securitized loan are more liquid—being more "tradable" and "gradable" (see §10.22)—investors in a distressed pool historically have been more likely to be able to cash out, by selling their securities at a discount.

While they are a relatively new class of assets, some differences have emerged in the typical workout strategies for securitized as compared to traditional real estate loans. For one thing, a secondary market began to emerge for troubled pooled loans; the increased uniformity of the loans lessens some uncertainties, which in a normal economic environment allowed potential buyers to calculate more easily an acceptable discounted price. A discounting process results in a set of new owners with a lower expectation of recovery; a discounted buyer is in a better position to act quickly to recover its own lower basis plus a profit margin. It is too early to say whether a market will continue to exist for deeply discounted troubled loans when a large volume is dumped into the market by widespread lender failures.

NOTE: These nonperforming troubled loans may be referred to as "toxic assets" or "legacy loans" depending on whether you are selling or buying.

Another phenomenon specific to securitized loan workouts is the repurchase option, in many loan pools, under which *the originating lender* may be contractually obligated to repurchase a defaulted loan. After such a repurchase, the investors have been made whole, and the borrower is back in contractual privity with its original lender (although that lender will not be in a good mood). The presence of those "repo" duties on the books of a lender generally will affect that lender's behavior, and its regulatory balance sheet, well ahead of the commencement of any actual enforcement activity on the loan.

The typical securitized loan's relative lack of workout flexibility may itself be forced to change in a deeply troubled real estate lending market. Lenders of any type whose workout strategy traditionally led to foreclosure would often make themselves whole (or partially so) by reselling the collateral at a foreclosure sale. But when there is little or no new financing available for real estate purchases, there are fewer buyers at a foreclosure. This increases the secured creditor's risk of being stuck with the property. With a curative foreclosure sale less likely, securitizing lenders and their servicers often instead look for opportunities to transfer the secured loan itself to a solvent assignee, keeping the original loan on their books in a modified and assigned form. This approach ameliorates the shortage of financing, taking advantage of a special servicer's typical discretionary power to allow loan assumptions, but not to make new loans. This strategy may be more palatable to securitizing lenders (given the constraints of a loan pool's servicing contract and promises to investors) than negotiating a loan modification with the original borrowers or foreclosing on the

real property collateral.

PRACTICE TIP: Early in a possible workout, the borrower's counsel may wish to explore (whether with the servicer, or just by independent examination of the documentation and the market) what, if any, kind of "takeout" loan assignment might be possible as an alternative. Depending on the lender, the loan pool, and the local market, some sort of arrangement that leaves a performing loan in place, even on a modified basis, may be an attractive alternative to foreclosures that are unlikely to "scare up" cash buyers.

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II. REQUIREMENTS FOR SECURITIZATION

§10.13 A. Getting the Asset "Off Balance Sheet"

Securitizing lenders approach credit risk differently than do traditional lenders. Holders of traditional loans carry both the credit risk of the borrower and the original lender. For example, the lender who purchases a partial interest ("participation") in a mortgage loan from the original lender generally acquires a proportionate part of the repayments made by the borrower, but in a sense, this money comes "through" the original lender. Thus, the participant's right to loan repayments from the property's income may be interrupted by a bankruptcy of either the borrower or the originating lender. Both are in line ahead of the participant as the funds flow through the loan structure, and either one may suffer losses because of business operations unrelated to the mortgage. So while the participating lender is lending against the real estate, a variety of other risks may affect repayment. In contrast, the whole point of a securitizable loan is to separate the financial asset from the borrower's general downside credit risk. The holder of a security derived from a pool of securitized loans expects no intervening business risks to interfere with the holder's receipt of payments made on the loan. As a result, conduit arrangers (see §10.1) and rating agencies (see §10.7) require a corporate or entity structure that segregates the leveraged asset, and usually require prefunding of anticipated contingency expenditures into segregated reserves or impounds at closing.

Historically, a key distinction between a traditional loan and a securitizable loan has been the invariable demand from the securitized market that the collateral assets be separated from the balance sheet of the notional borrower.

EXAMPLE: Q Corp. owns several retail shopping centers and would like to borrow a substantial loan or loans against one or more of its properties. Q Corp. (the notional borrower) forms new, separate corporate entities, called "special-purpose" or "single-purpose" entities (SPEs), for each shopping center to be funded. Each SPE bears its own obligations and has severe operating restrictions. By segregating each property into its *own* corporate entity, this structure theoretically better insulates individual properties from the possible ups and downs of Q Corp.'s financial condition, keeping the collateral in its own "bell jar," away from the business risks caused by Q Corp.'s other related entities.

By contributing the real property collateral securing the loan to an SPE, the owner (who in a traditional loan would be the borrower itself) removes the collateral from its balance sheet and exchanges it for equity ownership of the SPE. This separate SPE, usually in the form of a special corporation, LLC, or trust, becomes the contractual borrower, and adopts special "single-purpose" covenants (and in some cases charter documents) that prohibit it from doing any business other than operating the collateral property. Some originators or arrangers also require additional corporate structure changes; see discussion of SPEs in §§1.96, 10.14-10.17.

This isolation of the key assets creates some legal protection against the risk of losses from the operations of the (now-indirect) owner and, as discussed below, may make it easier for the mortgage-holding lender to gain control of the collateral property after a default. The SPE format also makes the loan's credit risk easier to describe and disclose to investors: each SPE borrower is an isolated entity which, in theory, owns only one thing and does only one thing. The rating agencies issue specific guidelines for the legal steps deemed necessary to sufficiently isolate an SPE from its original owner. The reward for correct structuring is that the agencies will assign a "clean" credit rating—one that evaluates only the asset and its immediate liabilities and ignores the credit risks of the parent entity.

NOTE: In April 2009 General Growth Properties (GGP), owner of more than 200 shopping malls, several master planned communities, and a collection of commercial office buildings and the single largest CMBS borrower in the United States, filed for bankruptcy protection. At the same time 166 SPEs owned by GGP also filed for bankruptcy, sending shockwaves through the industry. See Hudson & Wei, *Move by General Growth Rattles Malls' Investors,* Wall Street Journal, May 8, 2009 (which can be found on the Wall Street Journal website listed in the Directory).

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§10.14 B. Special-Purpose Entities (SPEs)

Real estate assets and businesses are like children: each one has its own unique little problems. From the securitizing lender's (and rating agency's) point of view, the purpose of a special-purpose (or single-purpose) entity (SPE) is to make sure that its loan won't be dragged down (or into court) by any such extraneous problems of the borrower's operating business, unless they relate to the actual property being financed. See background discussion in §§1.96, 10.13. SPEs are intended to isolate and insulate the loan (and the property and its cash flow) from the turbulence of other liabilities and business risks. The exact requirements for structuring the "borrower" entity, as imposed by a specific lender or rating agency, can be the most burdensome lawyering requirement of a securitizable loan transaction.

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1. Structure of SPEs

§10.15 a. Controls and Financial Covenants—The "Kon-Tiki" Approach

The SPE generally enters into various covenants and establishes control systems that keep the loan and collateral arrangements safe and also prevent it from engaging in the kinds of activities or other businesses that might create additional risks on its balance sheet. The whole point of an SPE (defined in §§1.96, 10.14) is that it exclusively focuses on the special purpose in question—the ownership and management of a specific financial asset. Rating agencies are able to assess the SPE's financial obligations based on the asset, rather than the original borrower or promoter, precisely because the original borrower's or promoter's other business is not expected to show up as a liability on the SPE's balance sheet. For this reason, SPEs generally are required to enter into elaborate covenants and corporate structural arrangements designed to assure that they will not, and to the extent legally possible cannot, indulge in other liability-creating activities. See §10.29 for examples of these negative covenants and restrictions.

The SPE's economic isolation changes the focus of the lender's repayment strategy and credit analysis. A traditional lender's credit analysis generally covers *both cash flow and liquidation* scenarios, to ensure that a loan investment can be recovered both in the ordinary course of business and after a borrower's default. Accordingly, the loan covenants address the collateral's net total revenue, the collateral's value (expressed as a loan-to-value ratio), and the *owner's* financial status (expressed in financial statement tests such as overall debt service coverage ratios and solvency). Such loan documents often require detailed financial covenants with periodic compliance reports that are monitored (often by the same people who originated the loan) in order to detect any "early warning signs" of trouble. By contrast, securitized loan documents typically use financial covenants that focus narrowly on their only significant source of funds: property cash flow. For example, borrowers in a securitized mortgage loan might expect stricter covenants on late rents and tenant vacancies as well as more focus on debt service coverage ratios than loan-to-appraised-value measures.

For this same reason, securitizing lenders are more likely to require impounds and reserves. See §1.97. An originator of securitized loans, who figuratively deposits the leveraged asset and its cash flow in a hermetically sealed envelope until the pool is liquidated or the investors are paid in full, will want to make sure that the money to operate the pool is put there too. Otherwise the cash flow to the investors would depend on postorigination support from outside the pool. For example, to deal with the risk of a lien for unpaid property taxes, a traditional mortgage lender may require a property tax reporting service or include covenants requiring periodic future impound payments for projected tax liabilities. On the other hand, properly securitized loans attempt to address this risk in advance by funding at closing —either directly into the SPE or into impound accounts under its control—all reserves needed to maintain cash flow.

Most securitizable mortgage loans have reserve accounts for anticipated taxes and insurance premiums. Most also have reserves for predictable maintenance and repair costs and any known environmental contingencies. Securitizing lenders are also more likely than traditional lenders to require that borrowers obtain insurance to cover operating risks, such as rental value insurance and business interruption insurance. Many also include reserve amounts for routine operating expenses such as management; this latter class may be negotiable depending on the arranger, the type of property, and the robustness of the rental cash-flow stream.

Negotiations over these terms and reserve amounts usually are influenced by a "Kon-Tiki" ethic: Like Thor Heyerdahl, the originating lenders of securitizable loans provision their financial assets for survival during a long voyage on the capital-markets ocean. Like rafts on the ocean, these borrower SPEs, due to their isolated SPE structures and covenants (see §10.14), do not have much opportunity to replenish their supplies (monetary reserves for repairs, taxes, and the like) until they reach the other shore—*i.e.,* maturity, a long way off. This gives arrangers and rating agencies every reason to insist that sufficient cash supplies are on board at the initial closing when "the raft sets sail."

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§10.15A b. Corporate Structuring

When using an SPE, lenders (whether traditional lenders, or investors represented by arrangers and rating agencies) often seek a corporate structure that incorporates independent elements, such as an independent director of a corporate SPE or a corporate managing member of a limited liability company SPE. These provisions often are combined with a supermajority vote requirement on any acts that might evade regular debt service obligations, such as merger, bankruptcy, liquidation, or repudiation of a debt. The underlying theory somewhat resembles the Air Force's missile silo practice of requiring two officers on duty who must use their keys simultaneously in order to launch a missile: the lender hopes that a borrower's decision to walk away from its debt service obligations is made less likely by increasing the number of required collaborators.

Some lawyers suggest that the independent directors agree in some written manner that their fiduciary duties favor the interests of the lenders as well as, or instead of, their traditional allegiance to the company's members or shareholders. This is an interesting and creative, if somewhat aggressive, approach; it remains to be seen whether such undertakings are enforceable or, for that matter, consistent with the inherent fiduciary duties of a director (or the counsel that advises him or her to do it).

WARNING: Attorneys should be aware, however, of the relative ease with which General Growth Properties was able to replace the directorial boards and management of its 166 SPEs in order to facilitate their massive bankruptcy filing. See Hudson & Wei, *Move by General Growth Rattles Malls' Investors,* Wall Street Journal, May 8, 2009 (which can be found on the Wall Street Journal website listed in the Directory).

Some arrangers and rating agencies may seek double-layer SPE protection by having the borrower SPE, which owns the leveraged asset, controlled by yet another SPE as its general partner, managing member, or sole shareholder, which in turn is controlled by or affiliated with the original owner/promoter.

For additional discussion of the structuring of SPEs, see §1.96.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/10 Securitized Commercial Mortgage Loans/§10.16 c. Bankruptcy-Remote Structures

§10.16 c. Bankruptcy-Remote Structures

The structural protections required of SPE borrowers rely more on corporate law, in contrast to the traditional *commercial law* protections that real estate lenders obtain against the risk of a borrower's financial deterioration, such as a perfected, first-priority secured lien on the real property collateral. Such security instruments, when properly maintained, entitle the lender to foreclose on its collateral. Even if its borrower files for bankruptcy protection, a perfected secured creditor has special rights in collateral for its loan and the proceeds that such collateral generates. However, many have learned from bitter experience that those commercial law protections do not guarantee that a lender can retrieve its collateral quickly, or intact, particularly if its borrower files for bankruptcy protection.

From the lender's point of view, bankruptcy is the ultimate example of failure of an SPE structure. Courts in the United States have gradually reinterpreted some of the bankruptcy rules protecting secured creditors, so that fierce-sounding legal principles are actually applied in lukewarm fashion. So-called "adequate protection" for secured lenders sometimes is inadequate; "indubitable equivalents" of lender's collateral are often anything but; and the "absolute priority" rule may be interpreted into tatters, which renders it rather less than absolute. The exact application of these rules is beyond the scope of this chapter. It will suffice to note that, under current bankruptcy law, secured lenders may face substantial delays and costs in re-acquiring their collateral from a bankrupt borrower or may be forced to take inferior economic substitutes.

As a result of this erosion of protection for secured creditors, rating agencies are unlikely to give a loan a "clean" rating—based on the value of the collateral—if there is a substantial chance that the property will be dragged into a bankruptcy proceeding. Historically, the major rating agencies' published legal structuring rules represent the degree of safeguard against bankruptcy risk that they regard as an acceptable minimum. These rules vary among rating agencies and over time, but generally all require that the collateral assets be isolated in an SPE, for reasons discussed above, and that the SPE take certain other steps to qualify as a bankruptcy-remote entity.

In addition to the structural corporate isolation of an SPE, securitizing lenders generally require that a leveraged asset's SPE owner become "bankruptcy remote" by adopting special charter and covenant restrictions intended to impair its ability to file for bankruptcy to the greatest degree possible. Bankruptcy-remote SPEs are those that have adopted various covenants and operating procedures that reinforce corporate separateness from their parent. These are designed to reduce the risk that the bankruptcy-remote SPE will later be pulled back into the parent's balance sheet in a parent's bankruptcy proceeding, potentially giving the parent's creditors a claim on the SPE's assets.

WARNING: Again, attorneys should not assume that these structures are foolproof. In a recent bankruptcy filing involving 166 supposedly bankruptcy remote SPEs, the parent corporation stated in court filings that the CMBS investors' objections to including the SPEs in the bankruptcy "appear grounded in the misperception that 'bankruptcy remote' means 'bankruptcy proof.'" See Hudson & Wei, *Move by General Growth Rattles Malls' Investors*, Wall Street Journal, May 8, 2009 (which can be found on the Wall Street Journal website listed in the Directory).

To further enhance these transactions, rating agencies and others evaluating SPEs usually seek a "nonconsolidation" legal opinion or other assurance advising that the SPE is unlikely to have its assets "consolidated" back with the parent. That risk can arise under the "veil-piercing" or "alter ego" doctrines of state corporation law, in which the SPE is disregarded as being a sham device, and the "real" owner is viewed as the holder of the SPE's assets and liabilities. See, *e.g., Las Palmas Assocs. v Las Palmas Ctr. Assocs.* (1991) 235 CA3d 1220, 1248, 1 CR2d 301; *Associated Vendors, Inc. v Oakland Meat Co.* (1962) 210 CA2d 825, 837, 26 CR 806; 9 Witkin, Summary of California Law, *Corporations* §§10, 15 (10th ed 2005). On legal opinions, see chap 8.

Nonconsolidation analyses also must take into account the related, equitable "substantive consolidation" remedies sometimes available under federal bankruptcy laws; see, *e.g., In re Owens Corning* (3d Cir 2005) 419 F3d 195. Typically, these doctrines employ a set of criteria by which two putative entities, the SPE and its "parent," can be evaluated—either as truly separate, or as a sham distinction that courts may equitably ignore. Those criteria include the

following:

- Adequate capitalization (or its absence);
- Separateness (or commingling) of funds;
- Respect (or disregard) for separate corporate governance and control; and
- Proper (or failed) maintenance of separate corporate status and required registrations.

See *Associated Vendors,* 210 CA2d at 837. Compliance with these distinctions and formalities is almost always the subject of mandatory loan covenants for securitizing SPEs (see §10.15), as well as a part of rating-agency criteria (see §10.7) for the loan pools they hold.

Securitizing lenders also seek legal protections to assure that the borrower/parent's original *contribution* of the collateral property into the bankruptcy-remote SPE will be left intact if later attacked in court. These protections may include assurances that the transfer is not a fraudulent conveyance, and an opinion that the transfer is a "true sale" that actually conveys ownership (as opposed to being recharacterized as merely a lien transaction, leaving true ownership of the property with the parent). Those determinations are highly technical conclusions that require substantial attention to commercial law principles and the emerging case law defining these concepts. In loans above a certain size or loans representing more than a certain percentage of a securitized loan pool, rating agencies often require borrowers to provide substantive nonconsolidation legal opinions in addition to traditional enforceability opinions.

PRACTICE TIP: The creation of new corporate entities, the identification of the proper officers or control structures, and the transfer of title in real property to those entities are steps that require time to execute and can, in some cases, even create taxable events. Borrower's counsel should make sure that the full panoply of required steps that a lender may impose, associated with creating a bankruptcy-remote SPE, is known and fixed well in advance of a planned loan funding date. This will help ensure that that the corporate formalities and any necessary management or financial steps are in place in time for closing. Unfortunately, it is very common for borrowers to find their securitized loan closing held up by reason of noncompliance with some seemingly minor corporate transfer or authority matter—which, nevertheless, proves to be a nonnegotiable structuring condition to the lender's release of funds.

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§10.16A d. Income Tax Concerns

Another reason the arranger and parent may wish to keep themselves separate from the "conduit" SPE relates to income tax considerations. A key early regulatory development in securitization was the adoption in 1992 of federal income tax regulations related to Real Estate Mortgage Investment Conduits (REMICs). See 26 CFR §§1.860A-1—1.860G-3T. Compliance with these criteria, similar but distinct from the SPE criteria provided by corporate law (see §§10.14-10.16), is necessary to ensure that the SPE and its pool of loan assets are not treated as part of the same *taxable entity* as its parent or arranger. These criteria may also constrain the workout options available to resolve troubled securitized loans. See also Warning in §1.96.

A particular focus of the tax regulations is what changes can be made to a pooled loan. Under current REMIC rules, for example, only a few types of limited amendments can be made to a loan in the "conduit" pool. See Loubier, *Securitized Commercial Mortgage Loans, Modifications and Workouts*, 22 Cal Real Prop J 31 (2004). The toolbox for conventional commercial real estate loan workouts often includes possible amendments beyond that limited scope —*e.g.,* changes to payment dates, prepayment dates, or penalties; nonrecourse provisions; the identity of the obligor— so in comparison the hands of servicers of REMIC-qualified loan pools often are tied. These restrictions have led mortgage bankers to request that the IRS expand the types of permitted amendment. See Thangavelu, *Industry Says Regulations Put CMBS at Disadvantage*, 11 Mortgage Servicing News 12 (June 2007).

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§10.16B e. Accounting Concerns

Another important source of guidance and underwriting criteria comes from the world of accounting. The U.S. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140 (SFAS 140) (which can be found on the FASB website listed in the Directory), *Accounting For Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* issued in September 2000, describes what a corporate or similar entity must do to be accounted as a "Qualifying Special Purpose Entity" (QSPE). An SPE must qualify as a QSPE to reliably be regarded under standard accounting practices as truly insulated from the entity that created it and donated its principal asset and, thus, actually *off* the parent's balance sheet for reporting purposes. Among other things, SFAS 140 requires very specific disclosure of securitization in corporate financial statements—to show clearly when assets are being moved off balance sheet—and the purpose for the use of an SPE.

By mid-2006, questions arose regarding the interpretation of how much power and control a pooled loan's servicers may retain over SPE assets, if the pool is to be regarded as truly separate. FASB expressed concern that a servicer who retains too much discretion and "creatively" varies from the stated enforcement criteria in its predisclosed terms might be acting more like an owner than a simple facilitator. That role would open questions about whether the SPE or trust holding the assets really is separate from its originator, its successors, or the servicers acting for them.

Accounting panels (including that of the Securities and Exchange Commission) debated in 2007 whether the SFAS 140 rule should be expanded to clearly permit a servicer to take such steps as waiving a due-on-sale provision, agreeing to substitution of collateral, or assisting with the disposition of REO ("real estate owned"; in other words, collateral recovered by the lender from a defaulting borrower). See Thangavelu, *Accounting Rules May Hamper Servicers,* Mortgage Line 12 (May 31, 2006); Rappeport*, The End of the Entity,* CFO.com (May 30, 2007) (FASB plans); Rappeport, *Congress Seeks Clarity on FAS 140,* CFO.com (June 21, 2007) (SEC plans). The Rappeport articles may be found at the CFO.com website listed in the Directory. That somewhat rarified dispute mostly was overtaken by the systemic downturn in real estate values in 2008, resulting in a general public policy preference for less discretion. See Selling, *FAS 140: Let's Call the Whole Thing Off* (Aug. 2008). The Selling article may be found at The Accounting Onion website listed in the Directory.

Practical clarity may not be likely in the near future, with a market mostly in stasis, waiting to see what new regime will be imposed to change the rules of the game (very much like the real estate lending market after the 1988 savings and loan crisis and before the creation of then new government regulators and federal rules in 1989). However, rule changes are starting to appear. In June 2009 the Financial Accounting Standards Board issued standard SFAS 166, *Accounting for Transfers of Financial Assets,* a partial amendment of SFAS 140, and the related SFAS 167, *Amendments to FIN 46R,* guiding the accounting treatment of certain specially structured legal entities including SPEs. The FASB explicitly states that these new rules, somewhat more conservative than originally expected, were taken into account in the 2009 round of U.S. federal bank balance sheet "stress tests," and will impact financial institution balance sheets beginning in 2010. FASB Press Release, *FASB Issues Statements 166 and 167 Pertaining to Securitizations and Special Purpose Entities* (June 12, 2009). SFAS 166 and 167 will be effective at the start of a company's first fiscal year beginning after November 15, 2009, or, for companies reporting earnings on a calendar-year basis, on January 1, 2010. The Statements of Financial Accounting Standards may be found at the Financial Accounting Standards Board website listed in the Directory.

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§10.17 2. Future of SPEs; Potential Hazards

The future of bankruptcy-remote SPE structuring methods is uncertain. Despite the heavy reliance that rating agencies and investors have placed on them since the mid-1990s, these corporate and commercial law structures and devices have not until recently been much tested in court. Among other things, there are strong federal law public policy rules that disfavor waivers of the right to file for bankruptcy. See, *e.g.,* California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 7, 11 (4th ed Cal CEB 2009). Quite a few of the early commercial mortgage-backed securities (CMBS) transactions were 10-year mortgages, originated in the mid-1990s. That first wave is just now coming due (or are in the process of refinancing). During the peak of enthusiastic mortgage lending, some CMBS arrangers offered up to 5-year interest-only periods. As a result, when the more recent waves of securitized loans on commercial properties come up for refinancing or collection, they may only have a few years of rent payment experience to review.

In an economic downturn, some of the creative bankruptcy-impeding covenants and bylaws imposed on borrowers by securitizing lenders might seem, to a court of equity, to be too facile an end-run of bankruptcy laws and prove unenforceable. However, legislative efforts to remedy the troubled real estate market by capital injections to banks or special statutory relief to provide forbearance may change the face of workouts, rather than leave courts to fashion equitable answers. Legislative action appears likely to change the rules, rather than letting the market play out according to the existing array of contracts, equity, and laws.

The initial donation of collateral to a bankruptcy-remote SPE (usually characterized as a capital contribution) may also prove to be subject to retroactive attack. Historically, commercial law has maintained a pragmatic attitude toward economic reality. Most commercial law rules encourage courts to recognize a cow as a cow, even when it is painted yellow and wears a sign labeling it a "duck." Among these rules are the following:

- Fraudulent conveyance laws (including the federal bankruptcy laws (see 11 USC §548); Uniform Fraudulent Transfer Act (CC §§3439-3439.12));
- The "substantive consolidation" rules in bankruptcy proceedings (see §10.16); and
- The recharacterization rules for security interests (see Com C §1201(b)(35)).

Such rules might be implicated when arrangers of securitized loan pools seek to transfer ownership of a loan asset nominally, but shift as much risk as possible back to the SPE borrower's parent and the loan originator. The use of severe repurchase obligations, parent environmental indemnities, and the like all might increase the possibility that a court will view the SPE as a sham, and instead (in defiance of the hopes of deal-structuring lawyers) conclude that the non-SPE parent is the "real" borrower and true primary obligor. That risk may be why some borrowers' counsel include significant exceptions about the effectiveness of such covenants and devices in their legal opinions. On SPE taxation risks, see Warning in §1.96.

Some enthusiasts have referred to procedures to limit a borrower's ability to file bankruptcy as "bankruptcy-proofing" rather than as creating "bankruptcy-remote" structures or devices. Most financing lawyers believe that "bankruptcy-remote" is a more prudent term of art. How remote is "remote" enough? When is an SPE's structure so lax or loose that its flaws are a source of liability for the originator, the arranger, or their counsel, or for the rating agency that dictated its design? Undoubtedly, the courts will establish that limit, as current portfolios of securitized mortgage loans are stress-tested by the recent real estate market downturn. Currently, the principal rating agencies (defined in §§1.93, 10.7) rely heavily on their respective "bankruptcy-remoting" requirements. As long as this occurs, bankruptcy-remote structures will be an important component of rated securitization transactions.

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§10.18 C. Guaranties and Other Third Party Credit Enhancements

In the traditional real estate lending world, a common fix for borrowers with credit quality problems is a guaranty from a separate, creditworthy party. Unfortunately, it is not that easy in the conduit-lending world. Each loan asset in a securitized pool must stand on its value based on known and standardized structures: if a guaranty or credit support makes a securitized loan dependent on some repayment source that is not part of the packaged and rated assets, then it probably won't be eligible for pool inclusion.

Pool investors want to look primarily to the collateral and the SPE (defined in §§1.96, 10.14) that is the principal obligor. Securitizing lenders will frequently seek credit enhancements from assets held by the SPE itself, such as cash reserves and overcollateralization, that carry no legal risk of veil-piercing. For that reason, the establishment of cash reserves at the outset of a securitized loan is much more common than in traditional loans. Another frequently used device is a repurchase or "put" clause, which may require the originating lender to repurchase a loan from the investors, at or near par, if it defaults. This shifts some of the risk of loss back from the pool to the originator and is thought by many commercial lawyers to create less veil-piercing risk than would an explicit parent guaranty. Third party credit supports may be used in some securitized loans to cover some specific and limited risks, as noted below, but with much more reticence and caution than in nonsecuritized loans.

In contrast, if a traditional lender determines that a proposed loan's intrinsic economic merits (such as its "LTV" ratio of loan amount to collateral value, or its "coverage" ratio of cash flow to debt service costs) do not justify the desired loan amount, then it may seek additional collateral, guaranties from creditworthy third parties, or cash reserves for contingencies. In some cases, letters of credit also may be offered or requested to secure specific payment obligations.

Credit enhancements that depend on outsiders create three problems for a securitization. First, such arrangements introduce a risk of nonpayment from a new party. As a result, the arrangers of the loan would have to investigate and disclose the creditworthiness and risk issues associated with the third party. This is an unattractive complication to the uniformity sought in required investor disclosure documents. Also, if repayment relies on outside parties, the rating agencies (defined in §§1.93, 10.7) will not give the securitized pool a clean rating based only on the collateral assets. As noted earlier, a lower rating lowers the price investors are willing to pay, and therefore increases the cost of funds, making the securitization transaction less attractive.

Second, "fixing" a single loan by adding enhancements that are not uniform to the entire pool of loans probably will impair the packaging of an otherwise homogenous pool. The unique aspects of the deal make the arranger less able to mathematically handicap the pool's aggregate performance, and less able to make accurate summary statements to investors about the credit characteristic of the pooled loans as a group.

This is *not* to say that securitized loans have no credit enhancements. Far from it. Such structures frequently incorporate special reserves, or letters of credit with a special payment tenor of permitted draws especially timed to support the pool's anticipated revenue streams. However, to work within the context of a securitized asset pool, these devices must be harmonized with it and be entered into solely for the benefit of the pool and its investors.

Third, generically speaking, guaranties and similar credit supports also detract from the asset-isolation protection sought from using an SPE structure. Credit supports may serve as evidence that the SPE is not in fact economically independent, which may be used to pierce the corporate veil between the SPE and its parent, in which case the SPE's loan obligations are re-exposed to the parent's credit risks. This veil-piercing risk, called "substantive consolidation" in a bankruptcy context (see §10.16), also is a consideration in a securitizing lender's analysis of bankruptcy risk.

However, many originators and arrangers prefer that *a few discrete risks* be covered by a guaranty. These tend to be the risks that in traditional lending stay with the property owner—the standard recourse exceptions to nonrecourse loans (*e.g.,* loss due to borrower fraud or waste) and environmental risks. Securitizing lenders and rating agencies usually will require that these discrete categories of risk be covered by certain types of limited guaranties from an interested third party, usually a principal, and ask for these assurances as a part of the loan package.

For additional discussion of credit enhancements, see §§1.59, 1.101.

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§10.19 D. Conventional Junior Debt

A loan with unique or unusual credit aspects will be harder, and sometimes impossible, to package efficiently into securitization. Most junior financing requires custom analysis, which makes it unsuitable for securitizable loans. See §1.100. However, a few hybrid forms of secondary financing have evolved that may be acceptable in some circumstances.

Of course, no senior lender, traditional or otherwise, is eager to allow any other liens on its collateral, even if junior to its own. Both traditional and securitized loans generally include covenants that seek to avoid most junior liens: the borrower is prohibited from deliberately creating a *consensual* lien as well as required to timely pay all obligations that might mature into a *nonconsensual* lien (such as property tax liens and mechanics' liens).

Traditional lenders may, in some circumstances, be willing to tolerate junior financing liens. The risks associated with such liens are complicated: the borrower's cash flow, the property's value, and the senior lender's ease of foreclosure are all affected, so a case-by-case analysis is usually necessary. Such discretionary judgment calls are needed both at origination for the loan and in any later enforcement actions. A traditional lender may be willing to take on those burdens of monitoring and judgment.

Those same burdens make most junior liens highly unattractive in a securitized loan pool, which is structured and priced to assume low administrative costs. The presence of unique features requiring assessment, such as a junior lender's rights and credit characteristics, makes the packaging and disclosure much harder for a pool that includes some loans with junior debt present. As a result, securitizing lenders rarely tolerate conventional liens. Most securitizing mortgage lenders allow the SPE borrowers (defined in §§1.96, 10.14) to incur only three kinds of debt: senior debt owed to that lender, liabilities owed to known tenants under their approved leases, and trade debt incurred in the ordinary course operation of the leveraged property.

Some arrangers and rating agencies (defined in §§1.93, 10.7) may be willing to permit some forms of relatively innocuous hybrid junior debt. While junior debt owed directly by the SPE borrower is highly disfavored, the SPE's *parent* may, in some cases, incur a limited amount of mezzanine debt (junior priority debt not secured by a lien or the property, but perhaps secured by a pledge of the parent's interests in the SPE) or investment in preferred stock bearing regular preferred-return dividend payments. (For a discussion of mezzanine financing, see §1.16.) In such cases, the junior financing often is closely assessed by the senior lenders, investors, or credit agencies to confirm whether its debt service requirements and enforcement rights are likely to interfere with performance of the senior securitized obligations. Additionally, lenders may seek to preserve the loan's pool eligibility by requiring that the borrower first obtain (and fund) a "no-downgrade" letter from the relevant rating agency, assuring that the proposed financing will not cause a downgrade or withdrawal of the pool's rating.

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§10.20 E. Application of Insurance Proceeds

Most real estate loans require the borrower to maintain certain insurance coverages against risks of loss, usually with the lender as an additional insured or direct loss payee. Securitizing lenders have a special concern about the proceeds from that insurance, as they generally have no recourse to any creditworthy parties other than the single-asset SPE (defined in §§1.96, 10.14). The cash flow from the SPE is the only source for repayment of the loan and payments, when and as due, to the holders of the securities. When loans are pooled into securities, the re-factored obligations to the ultimate investors often are to make specific fixed-amount payments on the securities over a specified period of time; for this reason, the qualifying loans are structured to ensure uninterrupted cash flow.

Thus, securitizing lenders are more likely than traditional lenders to require that insurance proceeds from a casualty be applied to rebuild the property securing the loan (and thereby restore cash flow from the property) rather than applying such proceeds to repay (and prepay) principal. This tendency is reflected in the mortgage loan insurance and condemnation covenants that they seek. Some securitizing lenders may also go further when a loan is originated to protect their ability to rebuild, such as by seeking up-front assurance from a municipality that, after a casualty, a rebuilt property will be allowed to re-acquire any "grandfathered" zoning exceptions, legal nonconforming use permits, or the like.

By contrast, traditional lenders generally want to have some flexibility after a loss to determine (usually with their borrower) whether the borrower will rebuild the damaged property or will pay down the loan. Traditional loan documents include covenants that specify certain circumstances or certain levels of loss that determine when insurance or condemnation proceeds must be paid directly to the lender. The more flexibility provided for in a loan, the less attractive it is to a securitizer.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/10 Securitized Commercial Mortgage Loans/§10.21 F. Loan Prepayments, Breakage, and Defeasance

§10.21 F. Loan Prepayments, Breakage, and Defeasance

In traditional loans, some lenders permit prepayment at any time, in which case the risk of prepayment is presumably factored into the lender's price. Some only permit prepayments in round numbers and at certain times, for the lender's administrative convenience. Some require a prepayment or "breakage fee," or "yield maintenance premium," which is calculated to replace the present value of the interest rate spread that the lenders would have received over the life of the loan.

The term "breakage" comes from the days when many lenders actually sent out and bought funds for each loan; in that practice, called "match funding," there would be a disadvantageous break in the lender's cash flow if it had borrowed funds for, say, 6 months at a certain wholesale rate, but the borrower to whom it in turn lent the funds at a retail rate only paid 3 months' interest.

Actual match funding is rarer nowadays, as the financial markets are more efficient, but the concept of breakage compensation has survived. A traditional lender's prepayment rules depend on its own sources of funds, its ability and inclination to price the risk, and its bargaining power as compared to that of the borrower.

Securitization repackages payment streams from loans, largely by risk (who's paying) and tenor (when they pay). As a result, investors are particularly sensitive to representations about the tenor of the underlying loans. The securitization marketplace puts pressure on arrangers to assure that the income from each pool somehow hits its target, because the income stream from the loan pool has already been carved up into new securities and resold to the investors on the basis of the principal and interest payments originally scheduled. Accordingly, the loan terms seek to penalize or mitigate prepayments in some manner to assure predictability. Thus, securitized loans frequently include terms that significantly discourage prepayments, such as a breakage fee, yield maintenance premium, or defeasance provision. Lefcoe, *Yield Maintenance and Defeasance: Two Different Paths to Commercial Mortgage Prepayment*, 28 Real Est LJ 202 (Winter 2000).

As noted above, a prepayment fee or a "yield maintenance premium," when aggressively priced, seeks to restore the lender to the same revenue position on a time-value-of-money basis, as it would have had if the loan had remained outstanding and paid interest as scheduled through maturity. Another mechanism, defeasance, is a concept borrowed from municipal bonds: the original collateral is replaced by reliable financial instruments (such as U.S. Treasury securities) that pay on the tenor required to cover the remaining debt service. In this manner, the original payment stream is left intact, even though the leveraged asset has been removed and no longer is collateral for the loan. (For a sample defeasance provision, see §10.30.) See Litwa, *Defeasance—A Practical Overview*, Mortgage Banking 71 (July 2000).

However, common law principles (which encourage free alienability of property and discourage enforcement of penalties) limit the reach of these terms. The legal resilience of some of these various antiprepayment approaches has not yet fully been tested in court.

The extent of a specific securitizing lender's willingness to tolerate some prepayment risk varies and may be subject to negotiation. Some originators will accept limited prepayment rights for a price, such as free prepayment in the last year of a loan term or a prepayment fee based on a declining fixed percentage rather than a present value calculation.

Some loan pool criteria require special repayment clauses, in an attempt to compensate for a mismatch between the tenor of original loans in a pool (*e.g.,* 30 years), and investors in the securitized derivative tranches, who may want to purchase 5- or 7-year maturities. Such pooling deals require that included loans incorporate "hyperamortization" clauses that attempt to force refinancing on a targeted payoff date (such as the loan's seventh anniversary) by imposing stiffer terms, such as markedly higher interest rates, a stricter requirement that property proceeds be applied to pay down the loan (allowing the lender to appoint new management), or the like. See §§10.31-10.32 for sample hyperamortization and change-of-management clauses. Unsurprisingly, these terms are unpopular with many borrowers, and as a relatively new feature, might still be surprising to unwary borrowers when second-stage restrictions and repayment changes are triggered. Second-stage remedies, if borrowers struggle to comply, may be viewed as a contributor to widespread default risk; they may or may not prove to be an enduring market development.

For additional discussion of hyperamortization, see §1.107; prepayment and defeasance restrictions are further discussed in §§1.102-1.105.

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§10.22 G. Lenders' Rights to Transfer Loans

Like prepayments (see §10.21), transferability is a hot-button issue for securitizing lenders. Most lenders prefer to retain the right to sell off their loans, particularly as an exit strategy if the loans deteriorate. However, in the traditional loan market, borrowers may be drawn to a particular lender because of its expertise in the relevant industry, its financial products, or a relationship with particular bankers within the lending organization. Borrowers may develop an expectation that "their" lender will stay with them, particularly if no default occurs. To effectuate that expectation, borrowers will sometimes ask for and get a covenant that the lender will retain a certain portion of the loan as its own asset. Similarly, borrowers, agents, and lenders in syndicated loans will often negotiate in detail about the extent to which various lenders can sell their shares in the loan or delegate their ability to vote about enforcement issues. In this context, the real dispute is about whose hands, and how many hands, hold the steering wheel: the borrower often seeks assurance that it will be able to continue to deal with the relationship-oriented loan officers who originated the loan.

In contrast, securitized loans are always absolutely transferable by the lender, and in fact transfers are planned. By definition, securitizing lenders plan from the outset to get their loans off their books as soon as possible and into a securitized loan pool owned by investors. The opinion of borrower's counsel sought in securitized loans often covers transferability of the loan interests as well as validity of the lending documents and conformance with law.

This transferability requirement also may make it more difficult to securitize loans secured by properties whose transfer requires regulatory approval, such as licensed properties like radio transmitters or facilities with liquor licenses. Finally, the purchase agreements between a securitizing lender and the arranger/pool trustee often require that the lender buy back loans that default in certain ways, so yet another transfer may occur in those circumstances.

The free transferability of lenders' interests in securitized loan pools makes them more liquid (easier to resell) and therefore more attractive investments. Mortgage-backed securities (defined in §10.1) are also relatively easy for an investor to evaluate with the use of rating agencies (see §§1.93, 10.7), standardized terms, and summary disclosure documents. Historically, the "tradable" and "gradable" nature of these securities has contrasted starkly with the refinancing market available to conventional loans, where any lender who wants to exit a loan must find another similar lender to take it out, with each sale negotiated as a unique transaction involving a nonliquid asset. See §10.12. However, it appears that the traditional commercial and securitized real estate loan markets are growing more similar; as they compete—and adopt each other's operating methods and credit approaches—that stark distinction may fade. See §§10.1-10.8.

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§10.23 H. Restrictions on Borrower Rights to Transfer the Property

Borrowers using securitized loans enjoy somewhat less flexibility in transferring their interests in property than those with traditional loans because of bans on prepayment and stiff prepayment premiums. See §10.21. These are imposed because of the nature of the representations a securitizer must make to its investors in the pool. A loan arranger must identify the type and credit profile of its borrowers to the investors in the eventual loan pool, often with some specificity in detailed covenants. Once those statements are made to a pool investor, the arranger usually is subject to liability under securities laws for material misstatements or omissions. Accordingly, the arranger wants to make sure that its representations about the identity and credit characteristics of the borrowers remain true. Thus, securitizable loans typically provide that a borrower cannot transfer its property securing the loan while the loan is outstanding, unless the borrower obtains the lender's permission (and, often, pays a fee). See sample form clause in §10.33.

Since, by the time a borrower requests the lender's permission to sell the real property collateral, the originating lender has typically transferred the loan into a pool and the obligation to service the loan has been transferred to the servicer, it is the servicer, acting for the investors, who has the right to approve or disapprove any transfer of the borrower's ownership of the property. This is usually accomplished by a transaction known as a "loan assumption," accomplished concomitantly with the borrower's sale of its real property. In a loan assumption, the old SPE borrower (defined in §§1.96, 10.14) is released from liability for the loan and the new buyer/borrower SPE assumes the obligations under the loan, subject to the servicer's approval.

Such loan assumption transactions require as much work as, and frequently more work than, the initial loan documentation, because the servicer is empowered to approve such loan assumptions only if the new buyer/borrower complies with all of the bankruptcy-remote and special-purpose structures, covenants, creditworthiness requirements, and other obligations of the original borrower. In loans over a certain size, or loans for which a substantial portion of the funds have been advanced and are at risk, the written approval of the rating agency may be required (see §§1.93, 10.7), which adds time and complexity to the loan assumption transaction. Many would-be buyers and sellers of real property become frustrated with the servicer's process of doing its diligence concerning the loan assumption transaction and the new buyer/borrower's compliance with the SPE and other structuring requirements. This frustration usually occurs when real estate sellers encumbered by securitized loans don't plan their exit strategy and fail to realize that such securitized loans require significantly more work to assign than do traditional loans.

PRACTICE TIP: Transfer-savvy borrowers, or even borrowers who may later need to rearrange their assets for corporate or estate-planning purposes, may wish to negotiate a one-time right to transfer the property (*e.g.,* between the original SPE and a new one), or possibly transfer the control interests in the SPE, when the original securitized loan is being documented.

In addition, to ensure the "special-purpose" nature of the borrower (as defined in §§1.96, 10.14), such loans typically provide that the borrower cannot transfer any interest in itself while the loan is outstanding, unless the obligor first obtains the lender's permission. Such limitations can hamper the borrower's flexibility in responding to changing market conditions during the term of the loan. An example of a typical restriction on transfer provision is included in §10.33.

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III. DOCUMENTATION ISSUES FOR SECURITIZABLE LOANS

§10.24 A. Degrees of Freedom in Drafting Loan Documents

Arrangers seek to simplify their job (and satisfy underwriting requirements) by requiring that pooled loans use standardized documentation. Packaging loans written on nonstandard documents increase the arranger's overhead by requiring that each asset be evaluated against a model for disclosure and risk-analysis purposes. Increasingly, arrangers' unwillingness to incur that expense and risk has driven the loan origination market into more cookie-cutter, form-driven practices.

Early attempts to securitize preexisting mortgage loans involved a substantial amount of postclosing diligence. Someone had to read each of the already-closed loan packages to assess whether the loans (1) conformed to the criteria for inclusion in the pool and (2) contained the necessary disclosures regarding the loans. As securitized mortgage transactions have increased, would-be originators are under greater pressure to use standardized forms for their loan origination to reduce the cost of that analysis.

The desire for standardization among arrangers extends beyond economic terms—to impose some uniformity on the actual language employed in loan documentation. Even loan pools that include a group of differently documented obligations may require that certain clauses or matters be handled in a uniform textual fashion. To address these legal needs, arrangers may require that generic covenant riders be appended to an otherwise conventional set of loan documents.

A key issue in the loan securitization market is reducing administrative costs. For this reason, many arrangers and their professionals will require that specific language be adopted or amended into loan or corporate documents, both in the original loan and during any loan assumption by a buyer of the property securing the loan, *even though* similar or sufficient clauses already address the same issues. Thus, even if a legally trained reader would easily ascertain that the existing documentation *covers* a specific securitizing lender's preferred risks and issues, the lender may insist that its own language be used. To many lenders in that market, the whole point of standardized language is to *avoid* having to pay a legally trained reader to sort out those matters.

Securitizing lenders frequently seek covenants from a borrower agreeing in advance to reaffirm, *or modify,* their various structural and covenant arrangements on *each* occasion when the loan is transferred to a new lender or pool servicer. An example of such a "secondary market" undertaking is included in the form clause in §10.28. This is a "second cousin" of the traditional real estate loan's requirement that tenants reaffirm their lease terms from time to time in writing to facilitate possible future refinancings. But it is a larger and more powerful cousin. In a conduit loan, the borrower is called on to agree not only to privity with presently nonexistent parties, but also with such unknown changes to their legal rights as the second lender's forms may dictate. The limits to enforceability of such clauses are not yet clear.

For further discussion of the strictures imposed by the need for standardized documents, see §1.92.

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§10.25 B. Incomplete or Defective Documentation

Loans placed into a securitization pool will be reviewed, after closing but before pooling, for completeness of documentation and conformance to the pool requirements. Loan originators might sometimes fund over deficiencies to be corrected postclosing. Arrangers have little reason to consent to such matters; if the deficiencies still exist when the arranger reviews the loan, it may be rejected from the pool.

To conform to their underwriting, disclosure, and economic requirements, pool arrangers seek to confirm that each of the loans selected for inclusion in the pool meets the criteria established for that pool. Some kind of documentation review process is generally employed. Of course, the same matters generally are reviewed by traditional lenders or their counsel during the closing of a conventional loan. What is remarkable here is that the arranger's advisors get a second bite at the apple, postclosing: at a time when the borrower has possession of the loan funds and the originating lender has somewhat less leverage to fix omissions. To return to our Kon-Tiki example (see §10.13), it is as if Thor Heyerdahl boards the raft sometime *after* you set out and brings the paddle. He checks out your supplies and *then* decides whether he is going to guide you across the water. If you've left something out, the loan is found ineligible for the pool. Because of the various special rights and privileges often reserved in securitized documentation, the nonconforming borrower may be forced to redocument or renegotiate, or else his loan is left floating offshore on the capital-markets ocean without a paddle.

Of course, failure to properly document the basic attributes of a loan is always serious. A traditional lender who discovers an improperly perfected lien, or an incomplete chain of title of assignments, needs to fix it, both to survive an audit of its loan files and to assure minimally acceptable remedies to enforce repayment. A securitized lender and its arranger have the additional problem that flawed rights may render untrue their disclosure document on which investors have depended.

The competitiveness of the securitized marketplace for speed and low cost also puts pressure on lenders to close fast and on arrangers to review closed loan files quickly. Securitization does exert a downward pull on administrative overhead. Real estate lenders and their lawyers should be vigilant that this pressure does not result in substandard documentation packages.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/10 Securitized Commercial Mortgage Loans/§10.26 IV. CURRENT AND FUTURE TRENDS

§10.26 IV. CURRENT AND FUTURE TRENDS

Over the past two decades, a lender's role in the world of commercial loans has changed: Lending enterprises began to sell their expertise in credit analysis and loan origination separately from their ability to service loans over time or liquidate them when they default, because those roles have been decoupled. The sharp downturn in the real estate markets in 2008 and 2009 has now brought the incredible growth in securitized loans to a screeching halt. The unanswered question for traditional lending institutions is whether their borrower relationships, broader product mix, greater flexibility, and industry-specific expertise will sustain a competitive advantage that overcomes the lower pricing and quicker execution resulting from the unbundled lending functions and lower cost of funds in the securitized lending market.

The unanswered question for the securitized commercial mortgage market is whether originators and rating agencies can re-establish sufficient marketplace credibility, which was seriously impaired in the wake of the collapse of the subprime residential market, and the impending collapse of the commercial mortgage market. If so, securitizable commercial mortgages, and the bonds that back them, may once again become widely viable and attractive to investors at realistic prices. If not, more radical restructuring may be needed to persuade investors to continue putting capital into real estate lending using these vehicles. The process of correcting the perceived problems in the subprime residential mortgage securitization market, and other markets for mortgage-backed securities, will likely be influenced by increased regulation designed to restore investor confidence and lender discipline in securitization processes. Proposals include:

- Requiring loan originators to take more explicit responsibility for tracking the long-term performance of their underwriting staff;
- Requiring loan originators to establish systems of deferred compensation that make loan officers share in the losses generated by borrower defaults;
- Requiring loan originators to retain a portion of all originated loans on their own financial books, in order to provide an incentive for careful underwriting;
- Placing the responsibility for the assessment of borrowers' risk worthiness squarely on lenders rather than allowing them to effectively outsource this responsibility to rating agencies; and
- Changing risk models to incorporate observations from previous crisis periods, including low probability high-risk events.

See, *e.g.,* Benink, *Davos: Rethinking Basel II: Holding off on IRB Implementation—Recent Turmoil Shows the Internal Risk Models Of Many Banks Are Inadequate, Underestimating The Degree of Risk Exposure*, The Banker (Jan. 1, 2008). As current real estate and real estate finance markets continue to suffer systemic failures, these proposals and others have become the topic of multiple federal legislative initiatives. For example, in a new, widely debated policy informally called the "skin in the game" rule, one federal recovery initiative would require that lenders in some cases retain at least 5 percent of the principal stake (credit risk) in their originated loans. U.S. General Accounting Office, *Troubled Asset Relief Program: June 2009 Status of Efforts to Address Transparency and Accountability Issues,* GAO Report Number GAO-09-658 (June 17, 2009) (which can be found on the General Accounting Office website listed in the Directory).

Although the potential for interlender litigation over failed pooled loans is strong (see §10.11), to date, only a few reported cases have put the special characteristics of securitized loans, arrangers, and servicers to the test. There is, of course, a growing wave of reported workout cases where a "servicer" simply takes the place once occupied by the "lender" as its agent or assignee, but in causes of action that are well known to workout lawyers:

- A servicer who takes an assignment of a real estate secured note may be a holder in due course, just like a subsequent lender assignee, and so may take the loan free of some of the defenses the borrower might have against the original lender. See, *e.g., Ocwen Loan Servicing, LLC v Branaman* (ND Miss 2008) 554 F Supp 2d 645, 651.
- A servicer can be a "debt collector," subject to the fairness constraints of the Fair Debt Collection Practices Act

(FDCPA) (15 USC §§1692-1692p). *Oppong v First Union Mortgage Corp.* (3d Cir 2007) 215 Fed Appx 114.

- A servicer may seek appointment of a receiver because the servicer should be included within the class of persons eligible to do so under Fed R Civ P 66. See *Santibanez v Wier McMahon & Co.* (5th Cir 1997) 105 F3d 234, 241.
- A servicer who administers loans poorly may lose remedies and risk sanctions. *In re Parsley* (Bankr SD Tex 2008) 384 BR 138 (servicer lost motion to lift stay, and narrowly escaped court sanctions for "merely negligent bungling").
- Some of a servicer's routine postbankruptcy enforcement actions, like calling on a guaranty and transferring the secured loan, will not be a violation of the automatic stay. *Chase Manhattan Mortgage Corp. v Cordero* (SD Fla 2007) 361 BR 257, 262 (reversing bankruptcy court, and vacating sanctions against servicer when servicer called on guaranty on bankrupt borrower's FHA-insured mortgage).

But only a few cases confirm the special aspects of workouts with multiparty, vaguely lender-like entities. One early example, *LaSalle Bank Nat'l Ass'n v Nomura Asset Capital Corp.* (2d Cir 2005) 424 F3d 195, concerned a struggle among parties to a loan pooling arrangement. LaSalle Bank, the pool fund trustee, sued the loan originator and arranger (Nomura) for breach of warranties arising from the alleged poor quality of one troubled loan in the pool. The court carefully distinguished between the "single, ill-fated mortgage" and the larger obligations among the servicers and arrangers under their pooling and servicing agreement. The case turned on precise interpretation of the warranties in the servicing agreement, and the appellate court in part disagreed with the trial court's reading of how the securitization pool documents shared risks among originators and investors. Interestingly, concurrent securities fraud claims mounted by another investor were rejected by the same court. See *Steed Fin. LDC v Nomura Sec. Int'l, Inc.* (2d Cir 2005) 148 Fed Appx 66 (unpublished opinion).

NOTE: *LaSalle Bank* is likely a harbinger of more disputes to come, at both the loan pool and originating lender level, over loan quality and the complicated terms of pool agreements. The interlender liability cases of the 1990s may provide some guidance, but loan pool cases also include securities law overtones. See also *Orix Capital Mkts. v GMAC Commercial Mortgage Corp.* (Jan. 22, 2007, B184519; not certified for publication) 2007 Cal App Unpub Lexis 474, for an unpublished California case involving allegations of breach of contract against a loan pool originator. As a practical matter, at the borrower's level, the prospects for this kind of dispute and litigation risk likely will continue to constrain the underwriting flexibility of securitizing lenders.

Securitized loans have become a valuable part of the "tool kit" available to finance real property development and have grown to occupy a large percentage of the commercial real estate finance market. As they prove susceptible to economic downturns, their relative robustness will be thoroughly tested.

Securitized real estate lending has evolved over time. The practice grew up around pools of mundane, standardized residential mortgages and then expanded to commercial properties with a predictable rental income stream yielding "commercial mortgage backed securities" (CMBS). Currently, more diverse, and perhaps riskier, assets are joining the fray. In 2006, some Wall Street firms geared up to expand these methods to construction lending as well. See Thangavelu, *Panel Debates Construction Loan Securitization*, 15 Origination News 42 (Jan. 1, 2006). However, the adverse turn in the credit markets in 2007 and 2008, and the resultant tightening of loan availability, significantly curtailed this expansionist trend, which more recently was stalled by a lack of investor faith in sinking more capital into a troubled securitization environment.

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§10.26A A. Collateralized Debt Obligations

The economic environment for securitized real estate loans has been affected by the evolution, and incursion, of other related financing practices. In addition to traditional CMBS pools, the years 2000 through 2007 saw strong growth in the use of collateralized debt obligations (CDOs), a somewhat more flexible and heterogeneous type of debt instrument also often loosely related to real estate. CDOs, which emerged as a separate instrument around 2001, usually are not secured by static pools of loans like a CMBS pool. They may instead be supported by more-mixed types of collateral, pooling real estate assets that might include CMBS securities but also real estate investment trust (REIT) debt and single whole loans that do not fit into a strict CMBS pool profile. See Thangavelu, *CDOs Seen as a Growing Complementary Securitization Avenue*, 30 Nat'l Mortgage News 24 (Apr. 10, 2006). CDOs may be supported by a revolving pool of loans and related assets, any one of which may pass in or out of the collateral or be substituted for something similar during the pool's lifetime. See Thangavelu, *Servicers Stretched as Workload Grows*, Mortgage Line (Feb. 1, 2007).

The collateral pool that secures CDO debt securities can include a variety of lower-priority assets, such as subordinate real estate loans (secured by second liens, not first liens); "B-note" loans that share in the first-tier senior mortgage security but are contractually subordinated in payment to a senior A-note under an intercreditor agreement; and traditional "mezzanine" loans (secured by a pledge of the property owner's equity ownership interests, but not the property itself). All these junior types of debt have found their way into CDO pools, a capital market instrument that grew explosively from 2004 to 2008. See *US CMBS and CRE CDO; Moody's Approach to Rating Commercial Real Estate Mezzanine Loans,* Moody's Investors Service (Mar. 29, 2007).

Until the recent market downturn, the increased opportunity for liquidity created by these various types of junior loan interests led to their broad popularity, which had the important secondary effect of increasing the risk to *senior secured loans,* simply by increasing the presence of debt on the borrower's balance sheet. See Stein, *Subordinate Mortgage Financing: The Perils of the Senior Lender,* Real Est Rev 3 (Fall 1997).

NOTE: As the current systemic real estate and financing market downturn is analyzed, CDOs have emerged as one of the principal villains in the recriminations over sloppy underwriting and overly complex financial practices. The earliest results from the autopsies of failed financial institutions suggest that the appetite for CDOs, and their riskiness, exceeded sound financial practices. They continue to be an important phenomenon, if only as a cautionary note, both for those who rely on complex financial derivative securities markets for liquidity and for senior lenders who are considering whether to tolerate junior layers of debt.

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§10.26B B. New Challenges and Tools in Loan Administration

As the securitized loan markets expanded to embrace more complex loans, loan administration workloads increased as well. A servicer industry that once might have paid interest only to investors, collected loan payments from borrowers, and sent rare but formulaic default notices increasingly was expected to cope with more complex covenant monitoring, default trigger events, and reporting requirements. See Thangavelu, *Servicers Stretched as Workload Grows*, Mortgage Line (Feb. 1, 2007).

In 2007, the major rating agencies, including Moody's, Standard & Poor's, and Fitch, began to express the view that this market expansion, and the competition for deals that comes with it, led to deteriorating quality in loan underwriting and reduced loan reserve requirements. See Thangavelu, *Rating Agencies Eye CMBS Concern,* 31 Nat'l Mortgage News 12 (Apr. 23, 2007). Increased concern from rating agencies, and increased regulatory surveillance of the rating agencies themselves, resulted in downgrades of the SPE's debt instrument ratings (causing a higher cost of capital to the arranged pools, which contributed to their inability to amass additional capital for new financing). Inevitably, disputes over broken securitizations, and substandard loans included in them, increasingly land at the doorstep of the raters. Whether their methodologies, pricing, and exculpatory terms will continue to define a strong and healthy business (in loan pools and especially subprime loan transactions) will be a difficult issue for the next few years. How the courts will apportion liability for a flawed pool, as between originators, arrangers, trustees, rating agencies, and servicers, is a key unresolved question.

Another development in the enforcement of securitized loans is the increase in widely available technological assistance. With the advent of cheap computational power, more sophisticated software, and more pervasive Internet use have come more robust automated systems—including powerful imaging systems (so that more of the original instruments are visible to investors and others); automated covenant maintenance (with formulaic tracking and distributed analysis of changing economic, income, and property data); and more powerful investment, fund management, credit assessment, and collection systems. See Tadle, *Trustees and Technology in Securitization*, Int'l Fin L Rev (July 2005).

Technology may help make monitoring and enforcement by loan servicers more transparent and variances or problems more immediately visible. Moody's Investors Service stated as early as 2005 that it expected more proactive asset oversight from the fiduciaries responsible for reacting to asset cash flow, covenant breach, and default risks. See Tadle, *Trustees and Technology in Securitization*, Int'l Fin L Rev (July 2005).

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§10.26C C. Continuing Changes and Turmoil in Both Securitized and Traditional Lending Markets

The competition among various types of real estate lenders, both traditional and securitized, seems likely to continue to breed new points of similarity as well as new differences in the marketplace for lending capacity. Banks and insurance companies continue to adopt the more useful methods of securitization in their nonsecuritized loans as well, notably including SPE structuring, easier transferability among lenders, and more detailed, complex cash reserve requirements. Similarly, securitization arrangers and servicers seek to adopt and mimic or improve on the features of traditional lending that might make their products more attractive to borrowers. Thus, what started out with broad distinctions between the two worlds of lenders may not remain a clear distinction forever.

News reports of failed and failing lenders have gone from an occasional unwelcome surprise to an acknowledged pattern of systemic failure in an underregulated marketplace. The pattern of a few failures blossoming into widespread closures repeated itself, from the subprime market (see §10.4), to the broader general sector of lending institutions, which suffered an epidemic of failures and mergers resulting in relative credit paralysis in early 2009.

Although reported cases often lag behind by a year or two, the authors believe there is an increase in cases of alleged negligence in loan origination or servicing. Antifraud actions under the federal securities laws for misrepresentations about flawed pools are also likely to rise.

Recent events in the securitized loan market have increased the perception that negligent loan pool management carries significant liabilities. Those willing to remain in that market may adjust their disclosure practices appropriately. When real estate lending re-emerges, these changes likely will, for example, result in more conservative claims about the pool quality, caution in underwriting, and careful servicing and management to properly maintain a pool's economic characteristics once it is created.

If such cautious behaviors are implemented widely enough, more modest offering circulars may more conservatively describe the pools, resulting in less risky and more attractive investments. A price decline to better reflect true values has already begun to occur. Perceptions of risk and value in the commercial mortgage market may be impaired by the failures and mistakes in subprime residential lending, independent of the objective rent-generating capacity and credit quality of the commercial real estate collateral pool. Anderson, *Wall Street Banks Expect Billions More in Write-downs*, Int'l Herald Tribune, Feb. 19, 2008.

However, other commentators suggest that the real risks are more difficult to assess, due to the complexity and opacity of the structures used. A lack of lender incentives to assure postsecuritization loan performance may also suggest that the general credit crunch is a rational reaction to increased credit and underwriting uncertainties inherent in complex securitized structures. Benink, *Davos: Rethinking Basel II: Holding Off On IRB Implementation - Recent Turmoil Shows The Internal Risk Models Of Many Banks Are Inadequate, Underestimating The Degree Of Risk Exposure*, The Banker (Jan. 1, 2008).

Despite the current credit crunch, more careful pool management and favorable market reactions to regulatory reform or reallocation of risks through litigation ultimately may lead to the restoration of a viable, if smaller, market for securitized commercial loan products in the future. Nevertheless, whatever the state of the economy or the nature of the loan system, real estate practitioners will remain an important part of the financing process because the basic due diligence involved in mortgage lending will not change with securitization. However, attorneys may spend less time *negotiating* and *drafting* changes to increasingly standardized loan documents and more effort *explaining* the constraints imposed on securitized loans by the capital markets to borrowers and other parties accustomed to the rather different rules of traditional real estate financing.

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§10.27 V. FORM CLAUSES: SECURITIZATION PROVISIONS

Please note that these sample clauses are offered only for identification and demonstration purposes. Typically, they are included in the loan's deed of trust or, in some cases, a separate loan agreement (if there is such an agreement distinct from the typically terse promissory note). These clauses do not necessarily constitute best practices, industry-standard language, or appropriate terms for any specific transaction. Another potential source of useful form clauses is the Capital Markets Mortgage (CMM) form developed by the Capital Consortium, a confederation of seven industry trade associations. The CMM has been "rated" (in a hypothetical sense) by agencies such as Moody's Investors Service, Inc. and Standard & Poor's Ratings Group for use in commercial mortgage-backed securities (CMBS; see §10.1) and is a commonly used basis for documenting conduit and other securitized loans. Drafters may confidently rely on the market acceptability of its terms in many conventional situations. For an extensive discussion of the CMM by its principal drafter, see Forte, *A Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street,* 31 Real Prop Prob & Tr J 489 (Fall 1996).

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§10.28 A. Form: Cooperation and Further Assurances

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§10.28-10.33.

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10.28-1 Cooperation and further assurances

***Cooperation*. Borrower acknowledges that Lender and its successors and assigns may (a) sell, transfer, or assign this Mortgage, the Note, and other Loan Documents to one or more investors as a whole loan, in a rated or unrated public offering or private placement; (b) participate the Loan secured by this Mortgage to one or more investors in a rated or unrated public offering or private placement; (c) deposit this Mortgage, the Note, and other Loan Documents with a trust, which trust may sell certificates to investors evidencing an ownership interest in the trust assets in a rated or unrated public offering or private placement; or (d) otherwise sell the Loan or interest therein to investors in a rated or unrated public offering or private placement. (The transactions referred to in clauses (a)-(d) are hereinafter referred to as "Secondary Market Transactions.") Borrower shall, at Lender's expense, cooperate in good faith with Lender in effecting any such Secondary Market Transaction and shall cooperate in good faith to implement all requirements reasonably imposed by the participants involved in any Secondary Market Transaction (including, without limitation, a Rating Agency and/or an institutional purchaser, participant, or investor) including, without limitation, all structural or other changes to the Loan, modifications to any documents evidencing or securing the Loan, delivery of opinions of counsel acceptable to the Rating Agency or such other purchasers, participants or investors, and addressing such matters as the Rating Agency or such other purchasers, participants, or investors may require; provided, however, that the Borrower shall not be required to modify any documents evidencing or securing the Loan that would modify (i) the interest rate payable under the Note, (ii) the stated maturity of the Note, (iii) the amortization of principal of the Note, or (iv) any other material terms or covenants of the Loan. Borrower shall provide such information and documents relating to Borrower, the Property, the Leases, and any lessees as Lender or the Rating Agency or such other purchasers, participants, or investors may reasonably request in connection with a Secondary Market Transaction. Lender shall have the right to provide to the Rating Agency or prospective purchasers, participants, or investors any information in its possession including, without limitation, financial statements relating to Borrower, the Property, and any lessee. Borrower acknowledges that certain information regarding the Loan and the parties thereto and the Property may be included in a private placement memorandum, prospectus, or other disclosure documents.**

Comment: See discussion in §§10.7-10.8, 10.24.

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§10.29 B. Form: Negative SPE Covenants

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§10.28-10.33.

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10.29-1 Negative SPE covenants

***Negative Covenants Regarding Indebtedness and Changes in Borrower*. Borrower represents, warrants, and covenants that it shall not:**

a. dissolve, terminate, or materially amend the terms of its certificate of incorporation, articles of organization, operating agreement, or partnership agreement, as applicable;

b. enter into any transaction to merge, consolidate, liquidate or dissolve (or suffer any liquidation or dissolution), or acquire by purchase or otherwise all or substantially all the business or assets of, or any stock or other evidence of beneficial ownership of, any Person;

c. guarantee, indemnify, or otherwise become liable on or in connection with any obligation of any other Person;

d. at any time own any encumbered asset other than (i) the Property and (ii) incidental personal property necessary for the operation of the Property;

e. at any time be engaged directly or indirectly in any business other than the ownership, management, and operation of the Property;

f. enter into any contract or agreement with any general partner, principal, member or Affiliate of Borrower, or any Affiliate of the general partner or member of Borrower except upon terms and conditions that are intrinsically fair and substantially similar to those that would be available on an arm's-length basis with third parties other than an Affiliate;

g. incur, create, or assume any indebtedness, secured or unsecured, direct or contingent (including guaranteeing any obligation), other than (i) the Loan and (ii) indebtedness that represents trade payables or accrued expenses incurred in the ordinary course of business of owning and operating the Property. No other debt may be secured (senior, subordinate, or pari passu) by the Property;

h. make any loans or advances to any third party (including any Affiliate);

i. become insolvent or fail to pay its debt from its assets as the same shall become due;

j. fail to do all things necessary to preserve its existence as a Special-Purpose Entity, nor shall Borrower, any partner, limited or general, member or shareholder thereof, amend, modify or otherwise change its partnership certificate, partnership agreement, articles of organization, operating agreement, articles of incorporation, or by-laws in a manner which adversely affects Borrower's existence as a Special-Purpose Entity;

k. fail to conduct and operate its business as presently conducted and operated;

***l*. fail to maintain books, records, and bank accounts separate from those of its Affiliates including its members or general partners, as applicable;**

m. fail to, at all times, hold itself out to the public as a legal entity separate and distinct from any other entity (including any Affiliate thereof, including the general partner or any member of Borrower or any Affiliate

of the general partner or any member of Affiliate, as applicable);

n. fail to file its own tax returns;

o. fail to maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character and in light of its contemplated business operations;

p. seek the dissolution or winding up, in whole or in part, of Borrower;

q. commingle the funds and other assets of Borrower with those of any general partner, member, Affiliate, or other Person;

r. fail to maintain its assets in such a manner that it is not costly or difficult to segregate, ascertain, or identify its individual assets from those of any Affiliate or any other Person; and

s. hold itself out to be responsible for the debts or obligations of any other Person.

*** * ***

"*Special-Purpose Entity*" shall mean an entity that owns no interest or property other than the Property or interests in Borrower and otherwise is required to comply with the Special-Purpose Entity Provisions.

"*Special-Purpose Entity Provisions*" shall mean the provisions required by Lender to be included in an entity's organizational documents for such entity to satisfy Lender's bankruptcy-remote requirements. Such provisions deal with certain prohibited activities of the entity, subordination of certain indemnification obligations, separateness covenants, and, if applicable, antidissolution, voting, and independent director requirements.

Comment: See discussion in §§1.96, 10.14-10.17.

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§10.30 C. Form: Defeasance

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§10.28-10.33.

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

10.30-1 Defeasance

SECTION II. No Prepayments; Defeasance

A. For purposes of this provision, the following definitions shall apply:

"*IRC*" shall mean the Internal Revenue Code of 1986 as amended from time to time or any successor statute.

"*Defeasance Collateral*" shall mean U.S. Obligations (as hereinafter defined) that are identified by Maker (but if not identified by Maker, then selected by Holder) and that provide for payments prior, but as close as possible, to the Payment Dates for all Scheduled Defeasance Payments (as hereinafter defined), with each payment on such U.S. Obligations (together with any unexpended portion of any prior payment) being equal to or greater than the corresponding Scheduled Defeasance Payment.

"*Defeasance Deposit*" shall mean an amount in immediately available funds equal to the sum of the cost of the Defeasance Collateral and all costs and expenses incurred or to be incurred in connection therewith including, without limitation, any revenue, documentary stamp, or intangible taxes or any other tax or charge due in connection with the defeasance of the Loan.

"*Rating Agencies*" shall mean each of Standard & Poor's Ratings Group, Duff & Phelps Credit Rating Co., Moody's Investors Service, Inc., Fitch IBCA, Inc., or any successors thereto.

"*REMIC*" shall mean a "real estate mortgage investment conduit" as such term is defined in IRC §860D(a).

"*Scheduled Defeasance Payments*" shall mean all successive scheduled payments due hereunder on each Payment Date after the Defeasance Date (as hereinafter defined) including the amounts due on the Maturity Date.

"*Startup Day*" shall mean the "startup day," as such term is defined in IRC §860G(a)(9), of any REMIC that holds this Note.

"*U.S. Obligations*" shall mean direct, noncallable obligations of the United States of America reasonably acceptable to Holder.

B. Maker shall not be entitled to prepay this Note in whole or in part at any time. Notwithstanding the foregoing, (i) this Note may be prepaid in whole during the three (3) month period prior to the Maturity Date, without any Prepayment Charge (as defined in Section VI hereof) or similar premium, provided that no Event of Default exists; and (ii) no Prepayment Charge or similar premium shall be payable with respect to a prepayment resulting from Holder's election to apply any proceeds, paid in connection with a casualty to or condemnation of the Property, to reduce the indebtedness evidenced in this Note.

C. Notwithstanding anything contained herein to the contrary, at any time after the date that is the earlier to occur of (i) two (2) years after the Startup Day or (ii) five (5) years after the date hereof (if the aforesaid Startup Day shall not have occurred during such five (5) years and, in either case, provided no default exists hereunder and no Event of Default exists), Maker may cause the Property to be released from the lien of the Mortgage and the Defeasance Collateral to be substituted therefor as security for the Loan, subject to the satisfaction of the following conditions precedent (a "Defeasance Event"):

1. Not less than thirty (30) days' prior written notice shall be given by Maker to Holder specifying a Payment Date (the "Defeasance Date") on which the Defeasance Event is to occur;

2. All accrued and unpaid interest and all other sums due under this Note and under the other Loan Documents up to and including the Defeasance Date and all costs and expenses incurred by Holder or its agents in connection with the Defeasance Event (including, without limitation, the review of the proposed Defeasance Collateral and the preparation of the Defeasance Security Agreement (as hereinafter defined), legal opinions, mathematical verifications by a certified public accountant, and related documentation) shall be paid in full on or prior to the Defeasance Date;

3. Maker shall remit the Defeasance Deposit to Holder;

4. Maker shall execute and deliver, or cause to be executed and delivered, to Holder on or prior to the Defeasance Date:

a. a pledge and security agreement, in form and substance reasonably satisfactory to Holder, creating a first-priority security interest in favor of Holder in the Defeasance Collateral (the "Defeasance Security Agreement"), which shall provide, among other things, that any excess received by Holder from the Defeasance Collateral over the amounts payable by Maker hereunder, to the extent not required to make subsequent payments due hereunder, shall be refunded to Maker promptly after each monthly Payment Date;

b. a certificate of Maker certifying that all of the requirements set forth in this Section II.C have been satisfied and that the defeasance of the Loan is being undertaken to facilitate the disposition of the Property or other customary commercial transaction;

c. an opinion of counsel in form and substance reasonably satisfactory to Holder (i) from counsel to Holder stating, among other things, that Holder has a perfected first-priority security interest in the Defeasance Collateral and, if this Note is owned by a REMIC at the time of the Assumption (as hereinafter defined), if applicable, the Assumption will not adversely affect the federal income tax treatment of such REMIC under the applicable provisions of the IRC or cause such REMIC to incur any liability for federal income taxes; and (ii) from counsel for Maker stating, among other things, that the Defeasance Security Agreement is enforceable against Maker in accordance with its terms;

d. if required by Holder in its reasonable discretion, evidence in writing from the applicable Rating Agencies to the effect that the defeasance of the Loan will not result in a downgrading, withdrawal, or qualification of the respective ratings of any securities backed by this Note (including, without limitation, any securities issued by a REMIC that holds this Note), which ratings are in effect immediately prior to such Defeasance Event;

e. Maker and any guarantor or indemnitor of Maker's obligations under the Loan Documents for which Maker has personal liability shall execute and deliver to Holder such documents and agreements as Holder shall reasonably require to evidence and effectuate the ratification of such personal liability and guaranty or indemnity, respectively;

f. a ratification of all representations and obligations under the Loan Documents and such other certificates, documents, or instruments as Holder may reasonably require; and

g. if required by the Rating Agencies, a certificate from a certified public accountant that the Defeasance Collateral is sufficient to cover the remaining interest and principal payments under the Loan.

5. Maker, as directed by Holder, shall have duly endorsed or shall cause the holder thereof to have duly endorsed the Defeasance Collateral or shall have accompanied the Defeasance Collateral by a written instrument of transfer in form and substance reasonably satisfactory to Holder (including, without limitation, such instruments as may be required by the depository institution holding such securities or the issuer thereof, as the case may be, to effectuate book-entry transfers and pledges through the book-entry facilities of such institution or issuer) in order to perfect upon the delivery of the Defeasance Security Agreement a first-priority security interest in the Defeasance Collateral in favor of Holder in conformity with all applicable state and federal laws governing the granting of such security interests.

D. Maker appoints Holder as its agent and attorney-in-fact for the purpose of using the Defeasance Deposit to purchase for the account of Maker the Defeasance Collateral at then-prevailing market prices, using the

means and sources customarily employed and available to Holder to effectuate such purchases. The Defeasance Collateral shall be arranged such that payments received from such Defeasance Collateral shall be paid directly to Holder to be applied on account of the indebtedness evidenced by this Note. Any portion of the Defeasance Deposit in excess of the amount necessary to purchase the Defeasance Collateral and to satisfy Maker's obligations under Section II.C hereof shall be remitted to Maker following such purchase.

E. Upon compliance with the requirements of Section II.C hereof, the Property shall be released from the lien of the Mortgage and the other Loan Documents, and the Defeasance Collateral shall constitute collateral which shall secure this Note. Holder shall, at Maker's expense, execute and deliver any documents reasonably requested by Maker to release the Property from the lien of the Mortgage.

F. Upon the release of the Property from the lien of the Mortgage in accordance with Section II.E hereof, Maker may, at its option, assign the Defeasance Collateral and all its rights and obligations under this Note, the other Loan Documents, and the Defeasance Security Agreement to a successor obligor, which shall be a single-purpose, bankruptcy-remote entity and otherwise reasonably satisfactory to Holder (the "Successor Maker"), provided that the Successor Maker executes an assumption agreement in form and substance reasonably satisfactory to Holder (the "Assumption Agreement") pursuant to which Successor Maker assumes Maker's obligations under this Note, the other Loan Documents, and the Defeasance Security Agreement other than those obligations that are described in Sections II.C(4)(e) and (f) hereof (the "Assumption"). Maker shall, at such time, (i) deliver to Holder an opinion, in form and substance and by counsel reasonably satisfactory to Holder, stating, among other things, that the Assumption Agreement is enforceable against Maker and such Successor Maker in accordance with its terms and that, upon the Assumption, this Note and the Defeasance Security Agreement are enforceable against the Successor Maker in accordance with their respective terms; and (ii) pay all costs and expenses incurred by Holder or its agents in connection with the Assumption (including, without limitation, the review of the proposed Successor Maker and the preparation of the Assumption Agreement, legal opinions, and related documentation). Upon such Assumption, Maker shall be relieved of its obligations hereunder, under the other Loan Documents and under the Defeasance Security Agreement, except for those which are set forth in Sections II.C(4)(e) and (f) hereof.

G. Upon the release of the Property from the lien of the Mortgage in accordance with Section II.E hereof, neither Maker nor any Successor Maker shall have any right to prepay this Note pursuant to the other provisions of this Section or otherwise.

Comment: See discussion in §10.21.

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§10.31 D. Form: Hyperamortization

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10.31-1 Hyperamortization

For the purposes of this Note, the following terms shall have the following meanings:

"*Applicable Interest Rate*" shall mean (i) from the date of this Note through and including the Optional Prepayment Date (as hereinafter defined), a rate of _ _[*number*]_ _ percent (___%) per annum (the "*Initial Interest Rate*"); and (ii) from and after the Optional Prepayment Date through and including the date this Note is paid in full, a rate per annum equal to the greater of (i) the Initial Interest Rate plus two percent (2%) or (ii) the Constant Maturity Yield Rate [most recently published as of the date of determination by the Office of Debt Management of the U.S. Department of the Treasury or its successor for such maturity] plus _ _[*number*]_ _ percent (___%) (the "*Revised Interest Rate"*).

"*Optional Prepayment Date*" shall mean the Payment Date in _ _[*date*]_ _[*e.g.,* the month and year that is 10 years after the date of the Note].

From and after the Optional Prepayment Date, interest shall accrue on the unpaid Principal Amount from time to time outstanding on this Note at the Revised Interest Rate. Interest accrued at the Revised Interest Rate and not paid pursuant to this subparagraph shall be deferred and added to the indebtedness of this Note and shall earn interest at the Revised Interest Rate to the extent permitted by applicable law (such accrued interest is hereinafter defined as "*Accrued Interest*"). All of the indebtedness evidenced by this Note, including any Accrued Interest, shall be due and payable on the Maturity Date.

Interest shall be computed using the actual number of days elapsed for the relevant payment period, based on a 360-day year. In computing the number of days during which interest accrues on any amount outstanding hereunder, the first date from which interest is stated to accrue hereunder shall be included and the date of payment of such amount to Holder shall be excluded.

All payments made pursuant to this Note shall be made by check (subject to collection) or by wire transfer to Holder's office. Such payments must be received by Holder before 1:00 p.m., Eastern Time, in order to be credited as a payment received that date. All payments received by Holder shall be applied in the order of priority set forth in that certain Lockbox Agreement dated the date hereof, made by Maker in favor of Holder in connection with the Loan; provided, however, that upon the occurrence of an Event of Default (as defined in the Mortgage), Holder shall have the right to apply payments in such amounts and such order as Holder elects in its sole discretion.

All amounts due under this Note shall be payable without setoff, counterclaim, or any deduction whatsoever.

To the extent that Maker makes any payment or Holder receives any payment or proceeds for Maker's benefit that are subsequently invalidated, declared to be fraudulent or preferential, set aside or required to be repaid to a trustee, debtor in possession, receiver, custodian, or any other party under any bankruptcy law, common law or equitable clause, then, to such extent, the obligations of Maker hereunder intended to be satisfied shall be reinstated and continue as if such payment or proceeds had not been received by Holder.

Comment: See discussion in §10.21.

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Source: Real Property/California Real Estate Finance Practice: Strategies and Forms/10 Securitized Commercial Mortgage Loans/§10.32 E. Form: Change of Management

§10.32 E. Form: Change of Management

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10.32-1 Change of management

***Management*. If the Property is not managed by Borrower, it shall be managed either by an Affiliate of Borrower or professional property management company reasonably acceptable to Lender. The Property shall be managed in accordance with generally accepted management practices for properties of similar type and class in the vicinity of the Property. Management by an Affiliate or a professional property management company shall be pursuant to a written agreement approved by and collaterally assigned to Lender. In no event shall any manager be removed or replaced or the terms of any management agreement modified or amended without the prior written consent of Lender. In the event of default by Borrower hereunder or under any management contract then in effect, which default is not cured within any applicable grace or cure period, Lender shall have the right to terminate, or to direct Borrower to terminate, such management contract upon thirty (30) days' notice and to retain, or to direct Borrower to retain, a new management agent approved by Lender.**

Comment: See discussion in §10.21.

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§10.33 F. Form: Restrictions on Transfer of Leveraged Asset

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10.33-1 Restrictions on transfer of leveraged asset

***No Transfer/Encumbrance*. Without the prior written consent of Lender, Borrower agrees that it shall not Transfer, or agree to Transfer, all or any portion of the Property or any interest therein. For purposes of the preceding sentence, the following shall be prohibited:**

1. An installment sale agreement wherein Borrower agrees to sell the Property or any part thereof for a price to be paid in installments;

2. An agreement by Borrower leasing all or a substantial portion of the Property for other than actual occupancy by a space tenant thereunder;

3. A sale, assignment, or other transfer of, or the grant of a security interest in, Borrower's right, title, and interest in and to any Leases or any Rents;

4. Subjecting the Property to a condominium regime or transferring the Property to a cooperative corporation or similar association;

5. Any merger or consolidation involving Borrower;

6. Any voluntary or involuntary sale, conveyance, transfer, pledge, or encumbrance of a majority of the beneficial interests in Borrower or any general partner or managing member (or if no managing member, any member) of Borrower, whether occurring in one or a series of transactions; and

7. Any Transfer of any interest in Borrower or in the general partner or member of Borrower, if applicable.

Comment: See discussion in §10.23.

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Directory

For a discussion of Internet use by lawyers, online terminology, and a comprehensive list of Internet sites, see Internet Law and Practice in California (Cal CEB 2004).

§§1.92, 1.96, 10.13, 10.15A, 10.16

The Hudson & Wei article is available online at http://online.wsj.com/article/SB124163910180492861.html.

§3.1

The Federal National Mortgage Association (FNMA or "Fannie Mae") has a corporate informational website at http://www.fanniemae.com. That website has a section "For Home Buyers & Homeowners" that includes a variety of information on obtaining or refinancing a home mortgage.

The Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac") offers a variety of information on its Internet website address at http://www.freddiemac.com.

§3.32

Federal Reserve Statistical Release
Website: http://www.federalreserve.gov

§3.37

Federal Reserve Board
San Francisco: Telephone: (415) 974-2230
or (800) 722-2678
Website: http://www.federalreserve.gov

§4.2

FNMA
Website: http://www.fanniemae.com
FHLMC
Website: http://freddiemac.com/uniform

§§7.32, 7.44

California Secretary of State UCC Administrative Rules
Website: http://www.sos.ca.gov/business/ucc/administrative-rules.htm (see UCC §22601.4: Rules Applied to Search Requests)

The actions of the Article 9 Review Committee of the UCC's Permanent Editorial Board can be found at http://www.ali.org/index.cfm?fuseaction=projects.proj_ip&projectid=21.

§7.78

California Secretary of State
1500 11th Street
Sacramento, CA 95814
Telephone: (916) 653-3516
Website: http://www.sos.ca.gov;
http://www.sos.ca.gov/business/ucc/financing-statement.htm

§7.80

UCC Committee of the State Bar's Business Law Section
Website: http://www.calbar.org/buslaw/ucc/publications.htm

American Bar Association's Business Law Section Initial Report of the Joint Task Force on Deposit Account Control Agreements

Website: http://meetings.abanet.org/webupload/commupload/CL710060/otherlinks_files/int14.pdf

§§8.1, 8.3

State Bar of California
Website: http://www.calbar.ca.gov

§§8.3, 8.86

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§8.31

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Website: http://www.sos.ca.gov

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§10.4

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