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Welcome to another issue of the *Commercial Lending Bulletin*, a newsletter published monthly by the Commercial Lending Group at Lerch, Early & Brewer as a service to our clients. Here, you will find articles written by our attorneys covering a variety of current legal issues as they affect lending law. We publish the *Bulletin* as part of our ongoing efforts to provide our clients with responsive service and practical advice when needed.

This newsletter is sent via email in HTML format. If you wish to print a copy of the newsletter, you may access a .pdf version by following the "Printer-Friendly version" link below.

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Guarantor Escapes Responsibility Following Corporate Merger

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A Guaranty Guaranteed to Fail

A recent court decision held that where a co-owner of a business executed a guaranty three months after a loan was made to his related business, new consideration was required in order for such guaranty to be enforceable.

Commercial Lending Group News and Notes: The group welcomes Joel S. Aronson, plus an upcoming seminar alert.

Recordation Gives Purchaser Notice of Prior Security Interest

IN GEORGIA, A HOLDER OF A PREVIOUSLY ACQUIRED AND PROPERLY RECORDED COLLATERAL ASSIGNMENT WAS HELD TO HAVE A PRIORITY INTEREST OVER A SUBSEQUENT PURCHASER OF REAL PROPERTY.

In February 1998, Palmetto Capital Corp. made a loan to Café Franco Wholesale Inc. in the amount of \$200,000. The loan was secured by a note and security deed for real property in Newnan, Georgia (the deed of trust) that was recorded shortly after the loan was closed. In July 1998 Café Franco filed for bankruptcy. TravelBank Inc. purchased the loan from Palmetto, brought the note current, and in exchange accepted an absolute assignment of the note and deed. TravelBank financed the purchase of the loan through a new note payable to Palmetto, which was secured by a collateral assignment of the Café Franco note and security deed. Palmetto retained both notes and recorded both



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assignments. TravelBank made payments under this new note until May 2004.

However, in May 1999, TravelBank had recorded three deeds reflecting a foreclosure of the original security deed under which TravelBank was the purchaser. After a number of successive transactions, the property was acquired by Michael and Shirley Smith in May 2003. In September 2004 Palmetto gave notice of default on the Franco note to the Smiths and started foreclosure proceedings. The Smiths stated they had purchased the property in good faith without knowledge of Palmetto's interest.

The Smiths argued that the collateral assignment was actually a species of commercial paper and was subject to the UCC. Under the UCC, the title received in descent from an absolute assignment of the deed of trust is superior any title derived from the collateral assignment. The Court said that even if the collateral assignment was commercial paper and subject to the UCC, TravelBank's transfer of the power of sale to Palmetto was still effective under Georgia real property law. Additionally, the Court stated that the collateral assignment granted Palmetto the right to the income stream promised by TravelBank under its new note, and granted Palmetto the right to foreclose on the property securing that income stream if payment stopped. As a result, the main issue for the Court became whether the Smiths should be found to have had notice of Palmetto's rights under the collateral assignment. The Court found that the collateral assignment was properly recorded and, therefore, the Smiths were presumed to have purchased the property with knowledge of Palmetto's power to foreclose.

This case illustrates the importance of thorough searches prior to finalizing all loan transactions. Any prior liens must be satisfied of record because the court may well find that a subsequent purchaser or lender does not have priority when properly recorded prior instruments exist which give notice of the previous security interest in such property.

The case above is cited as *Palmetto Capital Corp. v. Smith, et. al.*, No. A06A1949 (Ga. Ct. App. 03/14/07)

Guarantor Escapes Responsibility Following Corporate Merger

A DISTRICT COURT IN LOUISIANA HAS DECIDED THAT, WHILE ONE GUARANTOR MAY ESCAPE LIABILITY FOLLOWING A CORPORATE MERGER THE REMAINING GUARANTORS MAY STILL BE HELD LIABLE ON THE GUARANTY.

JPMorgan Chase Bank N.A. made a \$9 million revolving loan and a \$3.7 million term loan to Pelts and Skins LLC. The revolving loan was guaranteed by Zachary A. Casey and by Amy Holding, Inc. The term loan was guaranteed by Casey individually, as well as by Amy Holding, Inc. and Pelts & Skins Export, Ltd. All guarantees contained waivers allowing JPMorgan to encumber the collateral without notice to the guarantors. On October 30, 2000, Amy Holding, Inc. merged with Pelts & Skins Export, Ltd. and the new entity became Amy Holding, LLC. Amy Holding, Inc. signed a reaffirmation guaranty after the merger acknowledging that the name change did not alter the prior guarantees. Amy Holding, LLC executed a guaranty in connection with the term loan on December 30, 2004 in which it guaranteed "all present and future loans" that Pelts owed to Chase.

The loans subsequently went into default, and on August 1, 2006 Pelts filed Chapter 11 bankruptcy. JPMorgan liquidated the collateral securities and filed suit against Casey and Amy Holding, LLC for \$7.5M on the revolving loan and \$3.4M on the term loan. However, the only guaranty executed by Amy Holding, LLC was in connection with the term loan, not for the revolving loan. JPMorgan argued that, due to the reaffirmation guaranty, Amy Holding, LLC, was liable for the revolving loan under the prior guaranty signed by Amy Holding, Inc. However, since the reaffirmation document was signed by Amy Holding, Inc., rather than Amy Holding, LLC, the Court did not agree, and found that Amy Holding, LLC was not liable for the revolving loan under either the reaffirmation guaranty or the prior guaranty.

Casey and Amy Holding, LLC then argued that their obligations under all of the guarantees were extinguished when JPMorgan released the collateral through liquidation because the liquidation was done without their consent. The Court disagreed with this argument. First, While Louisiana law states that a loan modification without the guarantors' consent extinguishes the surety "to the extent the surety is prejudiced by the action of the creditor," it provides that the parties may contractually alter this provision. Here, the guarantors waived the right to receive notice of further encumbrance of the collateral and further agreed that such action would not release the guarantors of their obligations.

The Court found that the remaining guarantors were liable under the original loans, despite the fact that Amy Holding, LLC did not specifically guarantee and therefore was not liable under the revolving



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loan. This case serves as a reminder to parties to state the liability of guarantors clearly and completely and to carefully consider the impact of mergers and reorganizations so as to avoid unintended consequences or costly litigation.

The case is cited as *JPMorgan Chase Bank, N.A. v. Zachary A. Casey, et al.* 2007 WL 763274 (E.D. La.)

A Guaranty Guaranteed to Fail

A WORD OF WARNING TO LENDERS REGARDING THE ENFORCEABILITY OF GUARANTIES: A RECENT COURT DECISION HELD THAT WHERE A CO-OWNER OF A BUSINESS EXECUTED A GUARANTY THREE MONTHS AFTER A LOAN WAS MADE TO HIS RELATED BUSINESS, NEW CONSIDERATION WAS REQUIRED IN ORDER FOR SUCH GUARANTY TO BE ENFORCEABLE.

In 2002, Brian Schubring worked as a general contractor for Schubring Builders LLC which he co-owned with his then wife, Michelle Schubring. In May or June 2002, Brian A. and Mary C. Luetzow hired Schubring Builders to construct a steel building. The Luetzows advanced Schubring Builders approximately \$100,000 as prepayment for work on the project. In October, Brian Schubring contacted Brian Luetzow and asked if Luetzow could advance to the company additional funds. On Oct. 28, the Luetzows issued a check to Schubring Builders for an additional \$100,000. At the Luetzows' request, the office manager at Schubring Builders personally picked up the check at the Luetzow residence and immediately deposited it into the company's bank account. The company, however, used the money to pay its bills rather than to help finance the Luetzow building project.

In late January or early February 2003, the Luetzows drafted a document entitled "Due on Demand Promissory Note" which identified Brian Schubring as the borrower of the second \$100,000 and provided that "for value received," Brian Schubring would repay the loan on demand. Brian Schubring executed the note, which was backdated to Oct. 29, 2002.

On Sept. 8, 2003, the Luetzows made a written demand upon Brian Schubring seeking payment of the balance of the loan and, in January 2004, after he failed to make payment, the Luetzows filed suit against both Schubrings seeking repayment.

Michelle Schubring filed a motion for summary judgment, arguing that the Luetzows advanced the loan to the company, Schubring Builders, and not Brian Schubring; thus, while the company was liable for the debt, neither of the Schubrings should be personally liable. She further contended that the promissory note constituted a defective effort to force Brian Schubring to guarantee the debt of Schubring Builders, as there was no fresh consideration. The trial court agreed with Michelle and granted summary judgment in her favor. The Luetzows appealed.

The Wisconsin Court of Appeals stated that new consideration is required for an effective guaranty of existing indebtedness. Where, as in the Schubring case, the guaranty included a recitation of consideration such as "for value received", the court explained that such language creates a presumption that consideration had in fact been given—which may or may not actually be the case. The appellate court said the question, then, was whether Michelle produced sufficient evidence to rebut the presumption. It concluded that she did.

The Court explained that where a guaranty is provided simultaneously with the principal obligation, they are construed together and may be supported by the same consideration. In the Schubring case however, although the guaranty was dated Oct. 29, 2002, it was not actually signed until early 2003. Additionally, the court found, there was no evidence that the Luetzows initially loaned Schubring Builders the money in reliance of the guaranty. The court found, therefore, that the original indebtedness could not supply consideration for the guaranty.

Interestingly, the court stated that an extension of time of payment on the original indebtedness and a promise of forbearance from pressing a claim are adequate consideration for the promise of a guarantor. However, in the Schubring case, neither the language of the guaranty nor the testimony by the parties evidenced a new exchange of promises regarding such an extension of time or forbearance. Brian Schubring testified that he just read through the document presented once and signed it. Thus, the court said the only thing left was a mere naked promise to pay the existing debt of another, which is not sufficient. The guaranty, therefore, was ruled to have failed for lack of valid consideration.

The lesson learned here is that a lender, in seeking a guaranty of repayment subsequent to the

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execution of a promissory note, must be able to properly document the consideration for the additional guaranty.

This case is cited as *Luetzow v. Schubring*, No. 2006AP2316 (Wis. Ct. App. 06/27/07)

Commercial Lending Group News and Notes



Lending Group Welcomes Joel S. Aronson

The Commercial Lending Group is proud to announce the addition of Joel S. Aronson, who will join the firm as a principal in October following seven years spent as a partner at the Bethesda-based firm of Ridberg, Sherbill & Aronson, LLP. Mr. Aronson concentrates his practice primarily in the areas of commercial and employment litigation, with a particular focus on creditor's rights issues and the representation of clients in the lending and financial industries.

Within the lending and financial industry, Mr. Aronson represents commercial lenders and captive finance companies in a variety of commercial disputes and litigation matters. He also serves as regional counsel for several of the nation's largest SBA lenders. Mr. Aronson is also active in the area of creditor's rights, representing creditors and bankruptcy trustees in both chapter 11 and chapter 7 cases, as well as bringing and defending fraudulent conveyance, preference and lift stay actions. He received his J.D. degree from the George Washington University National Law Center in 1982, and is admitted to practice in Maryland, Virginia, Pennsylvania and the District of Columbia.

Seminar Alert!

Coming soon, professionals from our group will be conducting a seminar on the impact of tightened credit standards on existing loan transactions. We'll discuss such topics as the workout process, the foreclosure process, and collection litigation and bankruptcy proceedings. Be sure to watch for a more detailed description, as well as a formal invitation to this insightful program, in the coming months.

We Would Like To Hear From You

We publish this newsletter as a service to our clients as a means to make them aware of certain aspects of the law. As always, we would like to hear feedback from our readers regarding the content of the newsletter. If there are items or topics you would like to see covered in future issues, or you have a suggestion concerning the newsletter itself, you may send them to Ben Harris at BJHarris@lerchearly.com, or via phone at 301-961-6096.

Additionally, a number of the Firm's other departments periodically issue highly informative newsletters on a variety of other subjects, including Real Estate, Community Associations, and Employment and Labor. If you would like to receive one or more of these newsletters, you may access them through our website, www.lerchearly.com. To be added to the mailing list of any of the above-mentioned practice groups, simply send an email to Mr. Harris at BJHarris@lerchearly.com.

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