

December 2007

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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.

We appreciate any feedback and invite you to contact us with any questions. If you do not want to receive any further newsletters from us, follow the link at the bottom of this email to be removed from our list of recipients.

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Dealing with the Troubled Loan

HIGHLIGHTS FROM THE "DEALING WITH THE TROUBLED LOAN" SEMINAR CONDUCTED BY JOEL ARONSON, CINDI COHEN AND ARNOLD SPEVACK TO OUR LENDING CLIENTS.

The following are some helpful tips when a loan goes into default:

- Perform a pre-workout/collection audit of the file and determine if any deficiencies currently exist in the loan documentation.
- Assess the nature of the problem. Is it temporary or of long duration. Is it related to the assets securing the loan or the business operations?
- Identify who is currently involved with the business and whether the circumstances warrant negotiations with the borrower, guarantor or other parties to the transaction.
- Before beginning workout discussions it is prudent to enter into a pre-workout agreement to set the ground rules that govern the negotiations during workout negotiations. The agreement should provide that any discussions of forbearance are not binding until documentation has been prepared and signed by all parties to the workout discussions.
- Do not finalize your agreement with the Borrower until the terms are approved by third parties

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where required (e.g. government agencies where repayment of loans are government guaranteed)

- When the parties come to an agreement regarding a workout of the loan, the appropriate forbearance or workout and restructure agreement should be executed by the borrower and all guarantors of the loan.
- Any forbearance or workout and restructure agreement should contain a reaffirmation of the loan by the borrower and guarantors, an acknowledgement of the default, a waiver of lender liability claims and defenses against the lender, circumstances for early termination (ie, bankruptcy, third party litigation), and rights and remedies upon termination
- In contemplating enforcement options, lenders need to look at the viability of success in determining the collection strategy.
- Receivership may be an option to enhance the value of the collateral and to preserve cash flow.
- File the appropriate claims in any bankruptcy proceeding.
- Conduct the appropriate lien searches before scheduling the sale of real or personal property so that all appropriate parties are notified of the proceedings.
- Review title searches to determine if federal tax liens are present which will require additional documentation pre-foreclosure or if any title defects must be cleared prior to foreclosure sale.

Creditor Allowed to Pursue both Judgment Lien and Foreclosure to Collect Debt

A COURT FOUND THAT A CREDITOR MAY PURSUE FORECLOSURE AFTER FAILING TO OBTAIN SATISFACTION OF A JUDGMENT LIEN.

In *Morgan Creek Residential v. Kemp*, Morgan Creek provided a letter of credit to Citicapital Commercial Corporation to secure the obligations of Morgan Creek Golf Club, LLC. Kemp, Haws and the other defendants were either members of Morgan Creek or principals of the members. The Golf Club requested a \$10 million loan from Citicapital to complete a golf course. The defendants were required by Citicapital to guaranty the loan in the aggregate amount of \$4.8 million. Citicapital requested further collateral, and Morgan Creek loaned \$2.8MM to the operating member of the Golf Club and then provided a \$1.4 million letter of credit to Citicapital as additional collateral for the loan. Citicapital ultimately made a \$6.5 million loan to the Golf Club.

Thereafter, as a result of mechanic's liens and other issues, Citicapital gave notice of a loan default and provided the Golf Club with an opportunity to cure. None of the members of the Golf Club took any action to cure, and Citicapital called the letter of credit, which Morgan Creek honored. Citicapital used the proceeds from the letter of credit to pay down the principal balance of the loan and the members restructured the remaining debt and sold the assets of the Golf Club to themselves. Morgan Creek sued, in various amended complaints, claiming it was owed i) equitable contribution from all co-obligors under the original loan, and ii) subrogation, under the theory that it was subrogated to the rights of the bank for whose benefit the letter of credit had been issued. The court dismissed Morgan Creek's complaint against Kemp and Haws and Morgan Creek appealed.

On appeal, Morgan Creek claimed that it was entitled to equitable contribution from Kemp and Haws because they were all obligated to answer for the Golf Club's debt and yet Morgan Creek was the only one who paid. The Court disagreed, pointing out that the liability under Morgan Creek's letter of credit was inherently different from the liability under Haws and Kemp's guarantees. The Court pointed to California statute as well as case law and stated that equitable contribution only applies where two parties have debts that are equal and concurrent and, thus, the liability should be shared in proportion to their coverage of risk. Here, the Court determined that since the fundamental obligations under a letter of credit and a guaranty (the one being a principal obligation and the other being secondary) are different, the theory of equitable contribution cannot be applied.

Further, Morgan Creek claimed that, under the theory of subrogation (which allows someone who has paid the debt of another to step into the shoes of the creditor and pursue the one who should have paid) it should be able to "assert Citicapital's rights under the written guarantees to obtain pro rata contribution from Kemp and Haws" for the money it paid under the letter of credit. The Court disagreed on this count also, stating that it was the Golf Club, not Haws and Kemp, that was primarily liable on the underlying debt. The Court further stated that subrogation, even if applied, would not allow Morgan Creek to assert rights against the guarantors who were, in essence, "third parties not in default to the beneficiary and not liable for the portion of the indebtedness paid by the call on the letter of credit." The Court opined that to allow Morgan Creek to proceed under subrogation would be inconsistent with the aim of subrogation, which is designed for those who pay debts for which another is primarily liable.

This case is a reminder to those who are asked to help out their affiliates – do not agree to do so unless you have a separate agreement regarding contribution or reimbursement or unless you are prepared to make payment and live with the consequences. It is cited as *Morgan Creek Residential v.*



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OUR SERVICES

Providing lenders with only the highest and most knowledgeable levels of lending counsel in all phases of commercial lending transactions.

Representing both borrowers and lenders in complex real estate and development transactions.

Advising and counseling in the structuring, documenting and closing of asset-based loans, and in the perfection of the lender's security interest.

Providing counsel to bank and non-bank lenders in closing government guaranteed loans under the 7(a), 504, B&I and "piggyback" loan programs.

Providing our clients with the

Earl S. Kemp et al., 153 Cal.App.4th 675.

- Depending on the collateral, it may be prudent to conduct additional marketing and promotion activities to stimulate competitive bidding at foreclosure (in addition to legal advertisement)
- Satisfy all post foreclosure sale legal requirements

Our attorneys are available to discuss particular concerns you may have, in general or for a specific loan regarding the workout or collection process.

Parol Evidence Permitted To Prove "Sham" Loan

EXTRINSIC EVIDENCE WAS SUCCESSFULLY USED TO DEFEAT THE CLAIMS OF A CREDITOR.

After acquiring a company, the new owner sued to recover on a promissory note executed in favor of the company prior to its acquisition by its then senior executive. The Appellate Court held that the executive was allowed to introduce parol evidence showing that the "loan" was really a creative form of compensation and that the promissory note was never intended to be binding on him.

Polygram Holding Inc. was acquired by a new company and came under new management. It brought an action against Al Cafaro, an executive of Polygram, for enforcement of a promissory note Cafaro made in favor of Polygram. After proving that the note was not paid according to its terms, Polygram moved for summary judgment, which the trial court granted. Cafaro appealed.

Cafaro sought to admit certain parol evidence to prove that Polygram had agreed not to enforce the note. Specifically, Cafaro offered his own affidavit and that of John Scher, CEO of a division of Polygram. Both affidavits stated that the previous CEO of Polygram had expressly told Cafaro that the loan at issue was actually a "sham" loan, designed to compensate him, and that it would be carried on the books as a loan merely to appease the parent company. Cafaro said the loan was intended to be forgiven without his being required to repay Polygram. As part of this understanding, the defendant alleged that he was guaranteed a bonus in excess of amounts needed to meet any interest payments on the loan until it was forgiven. The implication being that Cafaro's bonus would be increased to cover the interest so that he would not incur any out-of-pocket expenses in connection with carrying the loans. In addition, the CFO of a subsidiary of the company that subsequently acquired Polygram supported the fact that Polygram did indeed have a practice of compensating senior executives under the guise of "sham" loans. Finally, although subsequently instructed not to answer further questions based on claims of attorney/client privilege, Polygram's former general counsel, who signed the loan agreement on behalf of Polygram, testified that she was surprised that the plaintiff had sought payment of the loan in the first place.

The New York Supreme Court, Appellate Division stated that "absent fraud or mutual mistake, the parol evidence rule precludes a party from offering evidence to contradict or modify an unambiguous contract." Nevertheless, the court said parol evidence may be offered "to show that a writing, although purporting to be a contract, is, in fact, no contract at all." Given the affidavits and testimony submitted by Cafaro, the Appellate Court held that sufficient triable issues of fact were raised as to whether the loan was actually a loan at all, or merely a sham transaction never intended to be binding.

In light of these examples where outside evidence is being considered against creditors, the most prudent course of action whenever questions of liability are posed to a lender, is to refer the borrower to the loan documentation and not make extrinsic statements as to the purpose or enforceability of the loan.

(Case Cited: Polygram Holding, Inc. v. Cafaro, 42 A.D.3d 339, 839 N.Y.S.2d 493, 2007 N.Y. Slip Op. 06063, N.Y.A.D. 1 Dept., July 12, 2007)

Notice- Recordation/Grantor Tax Increases in Northern Virginia and Montgomery County in 2008

The cost of recording in Northern Virginia and Montgomery County will increase next year. Effective January 1, 2008, the "Regional Congestion Relief Fee" will be assessed at the time of the sale and transfer of real property in Northern Virginia (Arlington, Fairfax, Loudoun, Prince William, City of Alexandria, City of Falls Church, City of Manassas, City of Manassas Park). The legislature approved a fee of .40/100 to be paid by the grantor at the time of the recordation of the deed of conveyance to a purchaser. This fee is in addition to the existing grantor tax of .10/100 and will be based upon the consideration or the value of the

necessary resources to deal constructively with problem loans and the implementation of creative loan work-out arrangements.

PRACTICE AREAS

Business and Taxation

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Family Law

Health Care

Land Use and Zoning

Litigation

Real Estate Transactions

interest whichever is greater. Recordation tax on mortgage transactions will not change. In Montgomery County, Maryland, effective March 1, 2008, there will be an increase in recordation tax for deeds and deeds of trust in excess of \$500,000.00. In addition to the charge of \$6.90 per \$1,000.00 for consideration up to \$500,000, an additional \$3.10 per \$1,000 (or fraction thereof) (raising the tax to \$10.00 per \$1,000.) will be added to the tax for the amount of consideration or debt secured over \$500,000.

Commercial Lending Group News and Notes

All of us in the Commercial Lending Group want to wish you and your staff a very happy holiday season and best wishes for a happy new year! We look forward to working with you in 2008 in reaching your goals.

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 Mamie Brown at mabrown@lerchearly.com.

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 view one or more of these newsletters, you may access them through our website, www.lerchearly.com.

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