RECEIVER WARS:

Competing Rights to Rents and Profits Among Multiple Secured Lenders

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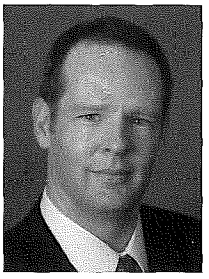

In an all-too-common scenario in these economic times, a borrower simultaneously defaults on two loans secured by an income-producing property, yet continues to collect the rent. The fed-up junior lender sues the borrower and has a receiver appointed to manage the property and collect rents in a receivership account. A few months later, the senior lender decides that its senior loan priority entitles it to the money collected by the receiver and demands the rent money from the receiver. You be the judge: Who gets the money? Senior lenders are often surprised to learn that, under California law, the money in the receiver's account will most likely be awarded to the junior lender.

Generally, under California law, priority among multiple secured lenders having assignments of rents and profits is determined by the date of recording of the lenders' interests, irrespective of whether the assignments are part of a deed of trust or a separate assignment of rents. California Civil Code Section 2938(b). This first-to-record priority, however, may be drastically altered in the context of enforcement by one or more of the secured lenders utilizing a receiver.

California law rewards secured lenders who take action to enforce their rights in rents and profits and, in essence, punishes those who do not. A junior secured lender who initiates an "enforcement action": – makes demand for payment upon tenants or obtains appointment of a receiver to collect the rents and profits

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the Cherryland Loan Documents in the Laser Pro forms but, especially in the large loan documents by major banks that have been drafted by seasoned lawyers, similar provisions may appear.

Fannie Mae and Freddie Mac: Fannie Mae and Freddie Mac each came out with new loan documents in 2011. There was both a reshuffling of provisions of previously existing numerous loans documents into an oversized CMBS-type loan agreement, and incorporating provisions of CMBS loan documents that would be important for secondary market transactions. Pre-2011 loan documents of Fannie Mae required a borrower's representation and warranty in the Borrower's Certificate that the borrower had been and would remain adequately capitalized and would be able to pay the indebtedness as it became due (which, in effect, created a full guaranty of the guarantor, as it would have to assure there was always sufficient capital). Current Fannie Mae documentation does not have an SPE requirement like Cherryland Loan Documents, but a "Bankruptcy Event" triggers a bad boy carve-out and within the meaning of the term Bankruptcy Event is if the borrower states in writing that it is insolvent (and this writer assumes a letter stating that the property is not performing and the borrower needs a loan modification restructure or work-out, would be construed as an admission of insolvency). Freddie Mac's 2011 CME loan documents include provisions similar to the Cherryland Loan Documents as well as an SPE covenant that "it will pay its debts and obligations as they become due". Freddie Mac's pre-2011 loan documents , include a provision that provides that the loan "shall not render the borrower insolvent", which creates an interesting argument as to whether that provided only for the moment in time that the loan was being made (which if the case, would question all underwriting standards) or prospectively (which if the case, would have required the borrower to have a crystal ball as to future economic events).

There has yet to be published an opinion of any California court that follows Cherryland, and therefore it may take time before there is a ripple effect (if at all, as it is not certain California will follow Michigan although this writer takes bets that it will). Most important on both new loans being originated and loans reaching maturity that are likely to default, guarantors must understand the far reaching effects of bad boy carve-outs – and when a bad boy carve-out becomes a strikeout.

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pledged to it – will be afforded first priority in all rents and profits received pursuant to the enforcement action unless and until a more senior secured lender initiates its own enforcement action. California Civil Code Section 2938(h). Once the senior secured lender takes its own enforcement action, then it will be entitled to all net income from rents and profits thereafter collected by the receiver (at least to the amounts owed to the senior secured lender).

Contrary to the conventional wisdom among secured creditors, in many circumstances the senior secured creditor will have no right to receive any portion of the funds held by the receiver collected prior to the senior secured lender's enforcement efforts. In Carlon v. J.G. Ruddle Properties, 2 Cal. 2nd 17 (1934), the California Supreme Court held that "the senior mortgagee, though a party defendant, made no effort to share in the fruits of the receivership" and thus was not entitled to any portion of the funds held by the receiver. To the contrary, the court held that the junior lienholder had a "special lien" upon the funds. Further, the court held that if funds remained after payment in full of the junior secured lender who brought the enforcement action, the funds would be payable to the borrower and not the senior secured lender.

The moral of the above (Aesop would be proud) is that a security interest in rents and profits is only effective if acted upon by the secured lender. A senior secured lender cannot simply rely upon the enforcement action of a junior secured lender to preserve and protect rents and profits for the benefit of the senior secured lender. The senior secured lender, if concerned about the rents and profits from the security property, should take affirmative steps to enforce its security interest in rents and profits by either making demand directly upon the tenants for payment of all rents due or by appearing in the junior secured lender's receivership action (or even filing its own action) and asserting its senior security interest in the rents and profits. Failure to act is not a good option.

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