

Michael J. Zerman

Publications

- California Licensing Requirements for Unregulated Lenders and Intermediaries, *California Real Property Journal*, 2015
- Practice Tip: Shared Appreciation Loans, *State Bar of California Real Property Law Section E-Bulletin*, May 2011
- Lending on Distressed Real Estate Notes: Business and Legal Issues, *Los Angeles Daily Journal*, October 2010
- California Lenders Should Think Twice Before Exercising Remedies Under a Material Adverse Change Clause, *State Bar of California Real Property Law Section E-Bulletin*, October 2010
- IRS Liberalizes Rules for Restructuring Mortgages Held by REMICS, *lawupdates.com*, December 2009
- New FDIC Guidelines Offer Helpful Hints for Real Estate Workouts, *lawupdates.com*, December 2009
- Don't Wing It! Practical Safeguards for Effective Mortgage Modifications, *Probate & Property*, June 2009
- Avoiding a Ground Lease Faux Pas, *Retail Law Strategist*, October 2004

Presentations

- Speaker, "An Introduction to Real Estate Finance Transactions", UCLA School of Law, March 4, 2020
- Speaker, "ALTA Survey Analysis for Real Property Acquisitions," California State Bar Association Webinar, March 1, 2016
- Speaker, "Real Estate Finance and Foreclosure in the Golden State: California's One-Action and Anti-Deficiency Rules," BOMA National Conference, June 1, 2010
- Speaker, "Converting Leases from Modified Gross to Net," BOMA Medical Office Buildings Conference, June 1, 2009
- Speaker, "Advanced Title Insurance Coverage and Endorsements," ICSC Shopping Center Law Conference, October 1, 2008
- Speaker, "Zen and the Art of Survey Analysis," ICSC Shopping Center Law Conference, January 1, 2008

Real Property Law Section E-Bulletin



Welcome to the May 2011 edition of the Real Property Law Section (RPLS) E-Bulletin.

Here are the features in this month's E-Bulletin:

- [Webinar: Conducting Environmental Impact Review on Endangered Species Act Implementation, May 20, 2011](#)
- [Final Phase of "Hot Topics" Series Covering a Variety of Business Practice Areas Offered by the Business Law Section Ends on May 25, 2011](#)
- [Joint Meeting of RPLS and Sacramento County Bar Real Property Section in Sacramento, June 13, 2011](#)
- [Save the Date: Real Estate and Law Symposium, Co-Sponsored by SPIRE \(Stanford Professionals in Real Estate\) and the Real Property Law Section, November 9, 2011](#)
- [Helen's Hints, by Helen Shin -- Set up your Facebook and Twitter Accounts. The State Bar Sections \(including the RPLS and CYLA\) are now on Facebook and Twitter!](#)
- ["Matt's Musings" by Matt Henderson](#)
- [Our Own E-Bulletin Cartoonist, Scott Miller!](#)
- [DRE Consumer Alert on Lawsuit Marketers Requesting Upfront Fees for Home Mortgage Relief](#)
- [Practice Tip: Shared appreciation loans](#)
- [Case Alert: First National Mortgage Company v. Federal Realty Investment Trust](#)
- [Case Alert: City of Los Angeles v Superior Court](#)
- [Case Alert: Ashley II of Charleston, LLC v. PCS Nitrogen, Inc. and 3000 E. Imperial, LLC v. Robertshaw Controls Co.](#)
- [The California Real Property Journal](#)
- [Section News: Kudos to the committee, sponsors, presenters and all attendees for a great 30th Annual Real Property Retreat, April 29 - May 1, 2011, at Torrey Pines](#)
- [Section News: Kudos to presenters, sponsor and attendees of the panel on Short Sale Dilemmas and Recent Developments held in Los Angeles on May 11, 2011](#)
- [Get to Know Our Subsection Chairs," introducing Randy Sullivan, Co-Chair of the Real Estate Sales and Brokerage Subsection](#)

Practice Tip: Shared Appreciation Loans Shared appreciation loans have experienced renewed popularity recently, helping to fill part of the void left by the decline in securitized mortgage products. A shared appreciation loan is a loan secured by real property that gives the lender a contingent deferred interest in the form of a share of (a) the appreciation in the value of the property, (b) a portion of the rents produced by the property, or (c) both.

In California, shared appreciation loans are permitted by statute: California Civil Code § 1917 et seq. provides that the lien of a deed of trust securing a shared appreciation loan shall secure principal, accrued interest and contingent deferred interest. Additionally, the statute provides that shared appreciation loans are exempt from California's usury laws, and that the relationship of the borrower and lender is that of a debtor and creditor, not a partnership or joint venture. In the absence of such a statute, a shared appreciation loan could inadvertently cause the lender's lien to merge into the borrower's fee interest in the property, thereby extinguishing the lien.

When drafting loan documents for a shared appreciation loan, attorneys should take care to follow a few requirements set

forth in the statute:

(1) Any deed of trust securing a shared appreciation loan must indicate on the document that it secures a shared appreciation loan.

(2) The definition of a shared appreciation loan in Civil Code § 1917(b) expressly excludes loans secured by owner-occupied residential property containing one to four residential units.

A loan secured by such property that purports to be a shared appreciation loan may violate California's usury laws, thereby providing numerous defenses to the borrower, including claims to recover past interest paid and treble damages from the lender. Additionally, the lender's lien could be extinguished by the doctrine of merger, as described above. Therefore, lenders should generally avoid making such loans. However, Civil Code § 1917.006 contains separate rules for shared appreciation loans made by local government authorities secured by owner-occupied residential property, and Civil Code § 1917.320 et seq. contains extensive rules for shared appreciation loans to senior citizens secured by owner-occupied residential property. Attorneys should carefully review such code sections before undertaking any shared appreciation loans governed thereby.

We would like to thank Michael J. Zerman of Zuber & Taillieu LLP in Los Angeles and Co-Chair of the Real Estate Finance Subsection for submitting this Practice Tip. mzerman@ztlp.com; www.ztlp.com.

Lending on Distressed Real Estate Notes: Business and Legal Issues

By Jan B. Brzeski and
Michael J. Zerman

The great real estate buying opportunity that was expected to follow the recent financial crisis has yet to materialize.

While the residential real estate market has thawed somewhat with the help of ultra-low-interest mortgages provided by federal government agencies, the commercial market remains frozen. Income-property values are down about 40 percent from the peak, but transaction volume remains a fraction of what it was a few years ago. Given that most transactions from the boom years of the mid-2000s were financed with 70 percent to 80 percent debt, virtually all of these properties are now worth less than the loan amount. Accordingly, banks hold the key to when and how the commercial investment market becomes unfrozen.

Distressed Note Sales

One option that we are seeing more frequently — and that we expect will be active in 2011 — is the sale of nonperforming notes.

The bank benefits by replacing a questionable receivable with cash on its balance sheet, while the buyer pays less for the note than he or she would pay to buy the underlying property directly. However, the buyer may need to pay all cash, because banks are generally averse to taking a writedown on an asset and then extending new credit on that same asset.

For buyers seeking financing for distressed note acquisitions, an emerging trend is to use a bridge loan as part of the note acquisition. Not all bridge lenders are comfortable lending on a nonperforming note, but for those who are able to do it, the returns can be attractive relative to the risk.

Sample Economics of a Distressed Note Investment

For example, suppose a \$10 million loan is sold for \$7.5 million, while the underlying real estate is worth \$9 million. A bridge lender might offer \$4.5 million of financing, representing a 60 percent loan-to-cost (LTC) and a 50 percent loan-to-value (LTV) based on the value of the underlying property. Normally a bridge loan on good property at 50 percent LTV would yield in the single digits, but in return for taking a note as security rather than real property, the bridge lender would receive a double-digit yield. Usually the buyer of the distressed loan is expecting an unleveraged return in the 20-plus percent range, making double-digit financing costs acceptable to many buyers.

Selected Business Issues

When lending on a nonperforming note, the lender usually does not have access to the same quality of due diligence available when lending on real property.

For example, the actual income and expenses of the property may not be available. Therefore, the lender and/or the distressed note buyer may need to build current cash flow projections from the ground up.

Purchasing a note from the bank is like purchasing a bank-owned property, but the bank expects to close even faster in order to justify its decision to accept an even lower price.

Bridge lenders typically know that they will either be paid interest and principal, or else they will need to foreclose, with the potential for a bankruptcy by the borrower adding time to the



foreclosure process. Lenders whose security is a nonperforming note have one more layer of uncertainty in that the buyer of the nonperforming note could file for bankruptcy in addition to the owner of the real property. For this reason, among others, lenders whose security is a note rather than real property need to be conservative in the amount they will lend.

Selected Legal Issues

A bridge lender should not assume that the note buyer and the original lender have disclosed all the material issues that might affect the value of the collateral. A comprehensive list of due diligence issues is beyond the scope of this column, but a few real examples that the authors have encountered in recent years include: i) the legal description in the original deed of trust omitted a material portion of the collateral; ii) imposition of property tax liens exceeding \$1 million that had priority over the lender's lien; iii) the secured property was conveyed (twice) to new owners without lender consent, despite due-on-sale restrictions; and iv) lawful street access to an office building was blocked by a stalled excavation project after loan origination.

Often, such issues are only discovered through a careful review of the loan files and certain updated reports, including a current title report and a Phase I environmental assessment. As a practical matter, there may not be enough time to complete such an extensive review, and few bridge lenders want to pay for it. Consequently, note buyers and bridge lenders should factor an appropriate price discount into the transaction to compensate for such risks.

The bridge lender should review a draft of the note buyer's purchase agreement before execution to insure that the note seller has made adequate representations, warranties and indemnities, which should be drafted to run in favor of the note buyer's successors and assigns, including the bridge lender.

Note financing is different from conventional real estate finance in several respects. The note buyer should execute a new promissory note and a security agreement in favor of the bridge lender; that grants the bridge lender a security interest in the note that is being acquired.

The California Commercial Code specifies a few different ways for the bridge lender to perfect its security interest, but the best method is for the bridge lender to obtain possession of the original note. Otherwise, the bridge lender could lose priority to a good-faith purchaser who buys the pledged note without knowledge of the bridge lender's security interest.

The Commercial Code provides that perfection of a security interest in a secured note also constitutes perfection of a security interest in the deed of trust securing such note. However, the bridge lender should also record a collateral assignment of the deed of trust, which gives constructive notice to third-party claimants. Additionally, if a collateral assignment is recorded, most title insurers will issue a CLTA 104.4 endorsement to the original lender's title insurance policy; that insures the bridge lender that the original deed of trust has not been modified or reconveyed and that the collateral assignment is effective. The 2006 ALTA Loan Policy gives a subsequent holder of the note insured status, and the bridge lender should obtain possession of the original lender's policy along with the original note and the other loan documents.

Whenever a loan is secured in whole or part by California real property, lenders must carefully consider the effects of California's One Action Rule and anti-deficiency rules, which provide, among other things, that a lender cannot sue the borrower directly on the note or take other legal actions against the borrower except as part of a judicial foreclosure action.

The penalties for violating the One Action Rule are severe: loss of the lender's lien on its real property collateral and, potentially, discharge of the debt. Therefore, if prior to the note sale, the original lender sued the borrower to collect on the note, then the collateral may be worthless.

Likewise, if after the note sale the note buyer sues the borrower on the note, then the bridge lender's collateral may be destroyed.

Finally, a bridge lender should anticipate that the note buyer may raise One Action Rule defenses if it defaults under the bridge loan. While the legal merits of such a defense are debatable, the risk can be mitigated through careful drafting of the bridge loan documents, including third-party guaranties with appropriate suretyship waivers.

Jan B. Brzeski is the principal of Standard Capital LLC based in Los Angeles and is the manager of a mortgage fund focused on originating and investing in short-term real estate loans.



Michael J. Zerman is a partner at the law firm of Zuber & Taillieu, based in Los Angeles. His practice focuses on real estate transactions, including mortgage finance, purchase and sale, leasing and construction agreements.



Real Property Law Section E-Bulletin



News from the Section:

Welcome to the September edition of the Real Property Law Section E-Bulletin.

Here are the features in this month's E-Bulletin:

- [Can't attend the Annual Meeting later this month? Live stream a real property law program directly to your home or office!](#)
- [The 33rd Annual Real Estate and Economics Symposium in November will include a panel from the Real Property Law Section - register now!](#)
- [Upcoming CEB programs on tax trends, commercial loan defaults, and bankruptcy](#)
- [Save the Date! Mixers to meet your fellow Section members to be held in Los Angeles and San Francisco in December](#)
- [A featured article: California Lenders Should Think Twice Before Exercising Remedies Under a Material Adverse Change Clause](#)
- [Case Alert: Los Angeles Unified School District v. Casasola](#)
- [Case Alert: Culver Center Partners East #1, L.P., v. Baja Fresh Westlake Village, Inc.](#)
- [Practice Tip: Remodeler training and certification required by September 30 for EPA's lead paint rule](#)
- [A pending lawsuit alert: rights to surface water](#)
- [An homage to our departing California Real Property Journal editor in chief, and upcoming deadlines for future editions](#)
- ["The Subsection Corner," keeping you up to date with the activities of our Subsections](#)
- ["Get to Know Our Subsection Chairs," introducing you, one by one, to the fine folks who chair the Real Property Law Section's Subsections](#)

A Featured Article: California Lenders Should Think Twice Before Exercising Remedies Under a Material Adverse Change Clause

The material adverse change ("MAC") clause has become a common provision in real estate loan documents. This clause typically provides, in broad terms, that a material adverse change in the financial condition of the borrower, the secured property, or any guarantor will constitute an event of default, upon which the lender may accelerate the borrower's obligations under the loan documents and exercise the lender's other remedies, including foreclosure. Given current economic conditions, lenders may be tempted to read the MAC clause literally, as a "catch-all" default provision for loans that are insufficiently collateralized, even though the borrower has not made any monetary defaults. This situation is most likely to arise in the context of construction loans, where the lender, not the borrower, is often required to fund monthly interest payments out of loan proceeds. While there is a dearth of authority on the enforcement of a MAC clause in California, several legal precedents should give lenders pause before taking action in reliance on a MAC clause.

MAC clauses have been most heavily litigated in the Delaware courts, typically in the context of corporate mergers and acquisitions. The most widely cited case discussing MAC clauses has been *In Re IBP, Inc. Shareholders Litigation, IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001), in which the Delaware Chancery Court rejected Tyson's assertion that a material adverse change had occurred and ordered Tyson, the buyer, to specifically perform the merger agreement. The court determined that "a buyer ought to have to make a strong showing to invoke a material adverse effect exception to its obligation to close." Furthermore, the court stated that the buyer must show that the material adverse change is "durationally significant," and that a "a short-term hiccup in earnings will not suffice". Subsequently, in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), the Delaware Chancery Court rejected the buyer's MAC claim and stated that "[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect clause. . ." The opinion noted that the Delaware Chancery Court has never found a material adverse change to have occurred and that "this is not a coincidence."

California law on MAC clauses is not as developed as Delaware law. However, in the case of *1601 McCarthy Blvd., LLC v. GMAC Commercial Mortgage Corporation*, (Case No. CGC-03-425848, California Superior Court), a San Francisco jury awarded an office building owner \$33 million in punitive damages after its lender declared a default under a MAC clause. The borrower had deposited a \$7.2 million lease termination payment into an impound account held by the lender. Pursuant to the terms of the loan documents, the impounded funds would be returned to the borrower when it found a replacement tenant. However, when the borrower leased the space, the lender attempted to renegotiate the loan documents to provide that the impounded funds would be used to pay down the loan balance. When this was unsuccessful, the lender asserted that there had been a material adverse change in the borrower's financial condition, constituting a default under the loan documents. In support of its argument, the lender showed that the mortgaged property had experienced a material decline in value, that rental rates had declined significantly, and that the property's income was insufficient to cover debt service. The jury was not persuaded, and it returned a special verdict finding that the lender breached its contractual obligations and acted with malice, oppression and fraud in committing a conversion of the impounded funds.

Several factors that may have influenced the McCarthy jury have also been addressed by the Delaware courts:

1. **Ex-post facto justifications are frowned upon.** In *IBP*, the Delaware court took issue with the fact that Tyson made no reference to material adverse change in its rescission letter, asserting the issue "post-hoc" instead. Likewise, in *McCarthy*, the lender approved two new leases, asserting its MAC argument for the first time after the borrower completed tenant improvements and the tenants had commenced occupancy.
2. **What you know and when you knew it may hurt you later in court.** For example, in *IBP*, the court noted that Tyson's statements and actions showed that it was previously aware of several issues that were the basis for its later assertion of a material adverse change. Similarly, in *McCarthy*, the borrower presented evidence that the lender had approved two leases even though it had earlier prepared a confidential asset resolution plan, not disclosed to the borrower, which provided that the impounded funds would not be released unless the vacant space was rented at above-market rates sufficient to cover loan payments.
3. **Attempts to avoid contractual obligations due to changes in general economic conditions are viewed unfavorably.** In *McCarthy*, the borrower performed its obligations under the loan documents, but the lender attempted to avoid its corresponding obligations because of a decline in market rental rates that the borrower could not control. The jury viewed the lender's actions as evidence of bad faith. In the *Hexion* case, the economy deteriorated significantly between the time the parties entered into a merger agreement (i.e., July 2007) and the specified closing date. However, the Delaware court held that the buyer's MAC claim failed. The

decision implied that it would be very difficult for a buyer to ever invoke a MAC clause to refuse to close a transaction.

While California law on the enforceability of MAC clauses remains unsettled, a few lessons can be gleaned from existing legal precedents: *First*, a lender should not invoke the MAC clause in a precipitous manner without giving adequate notice to the borrower and a reasonable opportunity to cure. *Second*, the lender should not deliberately conceal any information or hidden objectives from the borrower. *Third*, the lender should not assume that a general deterioration in market conditions gives it the unlimited right to declare an event of default even though the borrower is performing its obligations under the loan documents. *Fourth*, the lender should not use a MAC clause to exert pressure on the borrower to renegotiate essential loan terms. Any of the foregoing actions is likely to be used against the lender in court as evidence of the lender's breach of the implied covenant of good faith and fair dealing, and could be the basis for a damage award against the lender. Instead, lenders should make a concerted effort to act in a commercially reasonable manner at all times and, more specifically, to seek advice from experienced legal counsel before invoking a MAC clause.

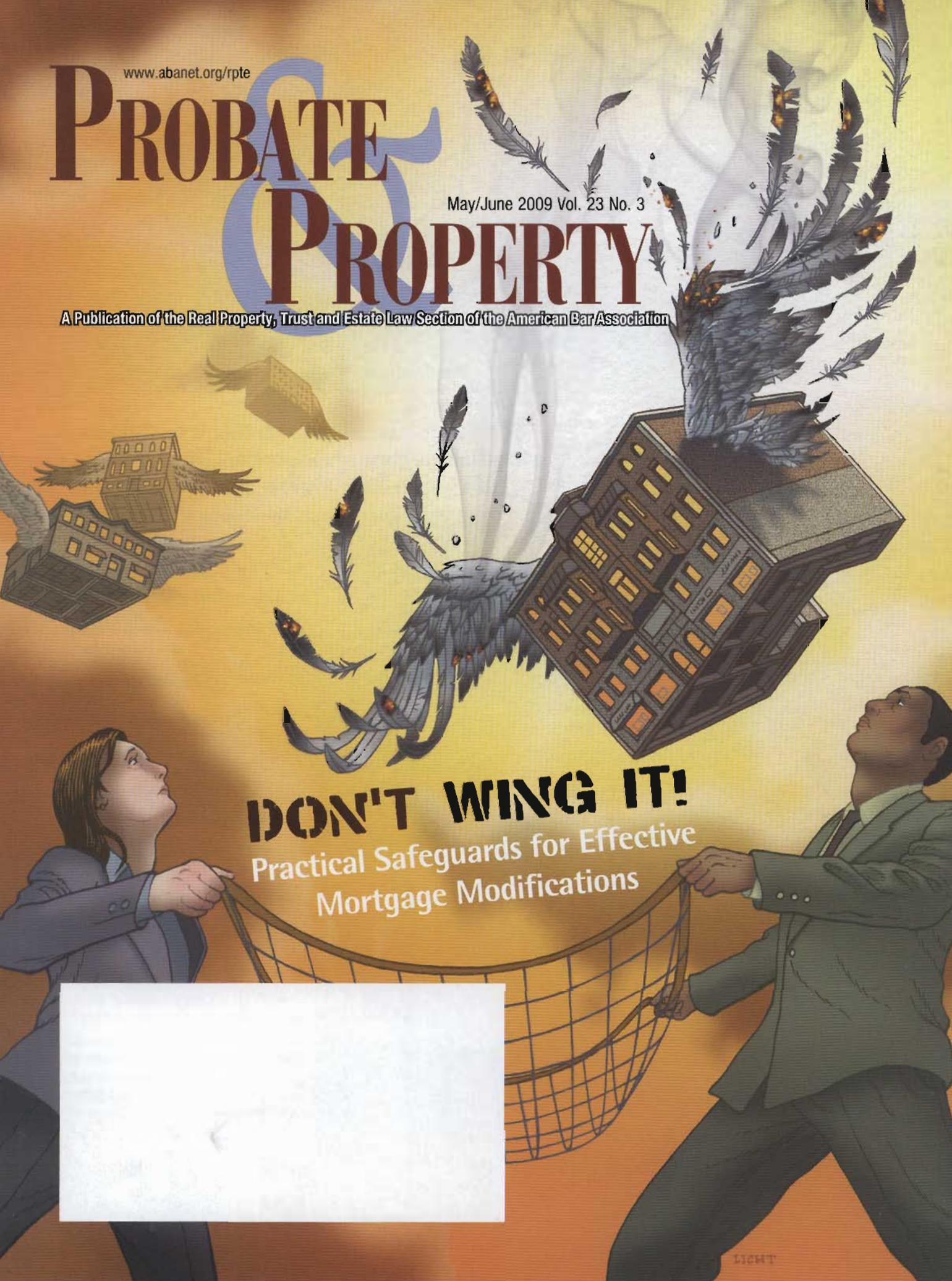
We would like to thank Michael J. Zerman (mzerman@ztllp.com) of the Los Angeles office of Zuber & Taillieu LLP, and a co-chair of the Real Estate Finance Subsection, for preparing this article for the Real Property Law Section E-Bulletin.

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DON'T WING IT!
Practical Safeguards for Effective
Mortgage Modifications





DON'T WING IT!

Practical Safeguards for Effective Mortgage Modifications

By Michael J. Zerman

As in previous real estate downturns, many mortgage lenders will elect to modify certain delinquent loans in their portfolios rather than exercise foreclosure remedies. By doing so, these lenders may avoid holding large amounts of real property that they cannot sell quickly without incurring significant losses. Loan modifications can result in "win-win" situations when distressed borrowers are able to continue making mortgage payments with the help of lender concessions (which may be of a temporary nature), and some lenders may be willing to grant such concessions in anticipation of the eventual recovery of the real estate market and the rise of property values.

But both borrowers and lenders must exercise caution when negotiating modification agreements. Especially for loans secured by commercial property, many legal issues must be carefully considered and factored into the decision of whether and under what conditions to modify a loan or instead to exercise other remedies, such as foreclosure or appointment of a receiver. This article will examine several important factors that mortgage lenders should consider when determining whether to modify a delinquent loan.

The Central Concern: Loss of Priority

Generally, any modification that increases the interest rate of the loan, shortens the maturity date of the loan, or increases the amount of the debt is considered a "material modification" that would adversely affect or "prejudice" the holder of a subordinate lien on the property. Many cases agree that mortgage liens, to the extent they secure non-obligatory advances above the original loan amount or increases in the interest rate of the loan, should lose their priority over a junior mortgage lien if entered into without the consent of the junior lienholder, because they impair the junior lienholder's ability to collect on its lien. See, e.g., *Gluskin v. Atl. Sav. & Loan Ass'n*, 108 Cal. Rptr. 318, 323 (Ct. App. 1973) ("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"); *Shane v. Winter Hill Fed. Sav. & Loan Ass'n*, 492 N.E.2d 92, 95-97

(Mass. 1986) (when first mortgage provided right of mortgagee to raise interest rate by 1%, but mortgagee raised rate by 1.25% without notice to second mortgagee, increase was prejudicial and unenforceable); *Shultis v. Woodstock Land Dev. Assocs.*, 594 N.Y.S.2d 890, 893 (App. Div. 1993) ("changing the interest rate on the loan and bringing the additional interest charges within the lien of the mortgage does work prejudice inasmuch as the change increases the total amount of indebtedness placed prior to the subordinate lien"); *Sackdorff v. JLM Group Ltd. P'ship*, 462 S.E.2d 64, 70 (Va. 1995) ("We agree with the principle that a senior lienor may not modify the terms of its agreement with the borrower so as materially to prejudice the rights or impair the security of junior lienors, without their consent."). This result may be different in some jurisdictions, depending on the specific wording of a state's applicable future advances statute or possibly the wording of the mortgage itself. Nevertheless, to avoid problems, lenders that desire to maintain mortgage lien priority ahead of junior liens should obtain the written consent of the junior lienholders to the modification agreement, which should be duly recorded so that future lien claimants will have notice of the modification.

The law is generally more lenient for other types of modifications, such as an extension of the maturity date, deferral of interest, or a reduction in the interest rate or the amount of the loan. An extension of time to repay a loan generally is presumed beneficial to junior lienors, not prejudicial. Modifications that extend the time period in which to pay off the senior loan, or reduce the interest rate or the amount of the loan, should not result in a loss of priority. See, e.g., *Resolution Trust Corp. v. BVS Dev. Inc.*, 42 F.3d 1206, 1215 (9th Cir. 1994) (lienholder's subordination not nullified by extension of term of superior loan without subordinate lienholder's consent because extension did not materially increase risk of default); *Lennar N.E. Partners v. Buice*, 57 Cal. Rptr. 2d 435, 440 (Ct. App. 1996) ("An extension of a senior debt that merely alters the date of payments generally does not adversely affect the junior lienholders. . . . [W]hen the obligation is increased, by an increase in the principal amount or an increase in the interest rate, the junior lienholder's position is worsened."). Nevertheless, even in these benign situations, lenders and their attorneys should be cautious about entering into an unrecorded loan modification agreement without obtaining title insurance, as discussed below.

Michael J. Zerman is counsel with the Los Angeles, California, office of Manatt, Phelps & Phillips, LLP.

Title Insurance for Mortgage Modifications

The lender's original American Land Title Association (ALTA) Loan Policy will not provide coverage for a subsequent loan modification. That policy insures the lender's lien on the insured land only as of the date set forth in Schedule A of the original policy. It does not insure the terms of a later modification unless an express endorsement is obtained to that effect, because the subsequent modification of the loan is a "post-policy" event that is otherwise excluded from coverage.

Most title insurance companies offer several alternative endorsement forms for loan modifications. Lenders may obtain coverage for mortgage modification agreements under ALTA Endorsement Form 11 (see Exhibit A on page 16). The ALTA Form 11 Endorsement is similar to the California Land Title Association (CLTA) Form 110.5 Endorsement (see Exhibit B on page 17 and discussed below), modified to include a credi-

Before issuing the ALTA Form 11 Endorsement or the CLTA 110.5 Endorsement, the title insurer will review the modification agreement and conduct a complete title and tax lien search to ascertain that nothing would render the modification agreement unenforceable or affect the priority of the insured mortgage after recording of the modification agreement. The title company's review usually includes the following matters:

- assurance that the parties to the modification agreement appear of record as the owner of the land (mortgagor) and as the mortgagee, respectively;
- the power and authority of the parties to execute the modification agreement;
- a determination that there are no encumbrances subsequent to the insured mortgage—if any such encumbrances are found, they will be set forth as exceptions in the endorsement unless the parties holding the encumbrances subject their interests to the insured mortgage as modified by appropriate subordination language in a recorded agreement;
- a determination that the holder of the note is a party to the modification agreement (by an inspection of the note if necessary);
- a determination that no work is in progress or recently completed (to avoid the superiority of mechanics' liens) by a site inspection or by requiring an affidavit from a creditworthy party for such work;
- a determination of the rights of any parties in possession, which may require additional exceptions to coverage; and
- a determination that no additional property is being added as security for the loan as part of the modification.

The lender should be equally concerned with all of these matters, and the modification agreement should contain borrower representations and warranties for many of these issues. The borrower, however, should cooperate

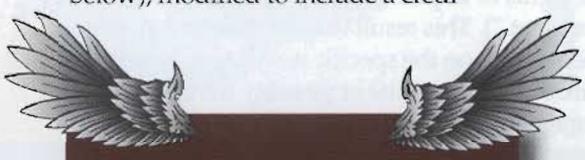
directly with the title company in requests for information. The title insurer is usually in a better position than the lender to evaluate and assume the risks presented by any defects revealed by its title search or any inaccuracies in the documents provided by the borrower.

Both the CLTA 110.5 Endorsement and the ALTA Form 11 Endorsement require that the modification agreement be recorded. Most title companies also offer custom endorsements (see Exhibit C on page 17), which insure against any loss of priority or impairment of the lien of the insured mortgage as a result of the execution of an unrecorded modification agreement, provided that it contains only certain "minor" modifications (for example, a short extension of the maturity date). Such custom endorsements are typically much less expensive than the CLTA 110.5 Endorsement or the ALTA Form 11 but are not applicable to modification agreements that contain material modifications that might be prejudicial to junior lienholders. In addition, even though a custom endorsement may be issued in some states without recording the modification agreement, the lender should consider recording the modification, anyway, in anticipation of further modifications, because their sequence may become confusing if some modifications are recorded and others are not.

More Traps for the Unwary: Disclaimers in Existing Loan Documents

Some lenders may rely mistakenly on language contained in the original loan documents or recorded subordination agreements that purports to allow the lender and borrower to modify the loan without the consent of junior lienholders. The *Restatement (Third) Property: Mortgages* (1997) appears to lend some credence to this position. Section 7.3(c) of the *Restatement* provides that:

If the mortgagor and the mortgagee reserve the right in a mortgage to modify the mortgage or the obligation it secures, the mortgage as modified retains priority even if the modification is materially prejudicial to the holders of junior interest in the real estate



Most title insurance companies offer several alternative endorsement forms for loan modifications.

tors' rights exclusion. The CLTA 110.5 Endorsement assures the lender that the modification agreement modifies the insured mortgage and does not result in priority of any junior lien over the insured mortgage, except as disclosed in the endorsement. The ALTA Form 11 Endorsement gives additional coverage beyond that of the CLTA 110.5 Endorsement in that it also insures the continuing validity and enforceability of the insured mortgage. Unless the title company agrees to remove the creditors' rights exclusion, however, the CLTA 110.5 Endorsement would be preferable, where available.

The *Restatement*, however, is not always an actual statement of current law. See *Restatement* § 7.3, Reporters' Note, recognizing that little judicial authority exists concerning the enforceability of terms in senior mortgages reserving the right to modify; that scholarly commentary is divided; and suggesting that the issue is best addressed by analogy to future advances made under the mortgage terms authorizing them. It is unlikely that a title insurer would be willing to rely solely on the fact that the original mortgage permitted future loan modifications, notwithstanding the degree of prejudice to a subordinate lienholder or impairment of its security. The junior lender will have a more difficult time arguing that the first lender lost priority because of a subsequent modification of the first mortgage if the first mortgage provides that the lender may modify the mortgage in the future and increase the amount of indebtedness secured in any manner it deems appropriate; or if the holders of the first and second mortgage liens have entered into a subordination or intercreditor agreement that provides that the senior lender may modify the mortgage at any time, including increasing the interest rate or amount of indebtedness or changing the maturity date. Some courts, however, still may question the enforceability of such an open-ended subordination agreement when the modification materially changes the junior lender's rights or ability to collect on its lien. Lenders should be especially careful not to prejudice a subordinated purchase-money mortgage because such lienholders are generally favored by the courts. See, e.g., *Gluskin*, 108 Cal. Rptr. at 322 (stating that "strong public policy reasons" exist to protect subordinated sellers).

The risk of defending against claims by other lienholders in such situations without obtaining their consent and subordination to the modifications may not be worth it to the title company, which is obligated to pay all defense costs as well as any loss. A subordinated purchase-money lender may be willing to consent to a modification to avoid a default under the senior loan. Mechanics' lien claimants, however,

often require that their liens be satisfied rather than subordinated to a modified mortgage. In such instances, the borrower or lender may be required to escrow additional funds to satisfy such liens concurrently with recording the modification agreement.

Preserving Guarantor Liability

The lender should make certain that all guarantors, indemnitors, endorsers, and the like execute the modification agreement or reaffirm their obligations at the time of execution of the modification agreement. Most state laws provide that a guarantor will be exonerated if the principal obligation is modified without the guarantor's consent. Ideally, the guaranty agreement should include a waiver of notice for modifications. Such a waiver, however, may be deemed ineffective. In California, a guaranty will also be unenforceable if a guarantor is already primarily liable for the repayment of the debt, such as when the borrower is a partnership and the guarantor is the general partner of such partnership. See, e.g., *Valinda Builders v. Bissner*, 40 Cal. Rptr. 735 (Ct. App. 1964); *Riddle v. Lushing*, 21 Cal. Rptr. 902 (Ct. App. 1962). This situation can arise inadvertently in the course of a loan modification if, for example, the borrower changes its entity status from a limited liability company to a partnership and the existing guarantor is a general partner of the new borrower. In such instances, the guarantor will be released from personal liability on the guaranty, notwithstanding its written consent to the modification. To flush out such issues in advance, lenders and their counsel should request an opinion letter from the borrower's counsel stating that each of the original loan documents, as modified, remains a binding and enforceable obligation of the parties thereto.

Bankruptcy Factors

If the lender requires additional security (such as additional property, a personal guarantee of the debt by the debtor or a third party) without advancing additional funds (or if the funds advanced are worth less than the additional security granted), the receipt of such

additional security may be deemed a preferential transfer under Bankruptcy Code § 547. If a bankruptcy proceeding is filed by or against the borrower within 90 days, the bankruptcy trustee could set aside the transfer of the additional collateral to the lender on this basis. See, e.g., *In re Spada*, 903 F.2d 971, 976 (3d Cir. 1990). A variety of other issues can arise in a bankruptcy, which are outside the scope of this article. Therefore, a lender



The lender should make certain that all guarantors, indemnitors, endorsers, and the like execute the modification agreement or reaffirm their obligations at the time of execution of the modification agreement.

should review carefully the borrower's financial statements before any modification to assure itself that bankruptcy is not imminent. In addition, the modification agreement should contain the borrower's representation and warranty that no bankruptcy or insolvency proceedings are pending or contemplated by the borrower.

Conclusion

Modification agreements can result in a "win-win" situation for both borrowers and lenders. Lenders, however, should take appropriate precautions to reduce inherent risks by following certain formalities, such as obtaining appropriate title insurance, recording the modification agreement, obtaining the written consent of all guarantors and junior lienholders, and receiving a clean opinion letter from borrower's counsel. ■

EXHIBIT A

ALTA Form 11—Modification of Mortgage'

ENDORSEMENT

Attached to Policy No. _____

Issued By

_____ Title Insurance Company

The Company insures against loss or damage sustained or incurred by the insured by reason of:

1. The invalidity or unenforceability of the lien of the insured mortgage upon the title at Date of Endorsement as a result of the agreement dated _____, recorded _____ ("Modification"); and
2. The lack of priority of the lien of the insured mortgage, at Date of Endorsement, over defects in, or liens or encumbrances on the title, except for those shown in the policy or any prior endorsement and except: [Specify exceptions, if any]

This endorsement does not insure against loss or damage, and the Company will not pay costs, attorneys' fees or expenses, by reason of any claim which arises out of the transaction creating the Modification, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:

- a. the Modification being deemed a fraudulent conveyance or fraudulent transfer; or
- b. the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination because of the Modification; or
- c. the Modification being deemed a preferential transfer except where the preferential transfer results from the failure:
 - i. to timely record the instrument of transfer; or
 - ii. of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

This endorsement is issued as part of the policy. Except as it expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsements, (iii) extend the Date of Policy or (iv) increase the Amount of Insurance. To the extent a provision of the policy or a previous endorsement is inconsistent with an express provision of this endorsement, this endorsement controls. Otherwise, this endorsement is subject to all of the terms and provisions of the policy and of any prior endorsements.

[Witness clause optional]

Date of Endorsement: _____

[Witness clause optional]

Date: _____

_____ Title Insurance Company

By: _____
Authorized Signatory

ALTA Form 11

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EXHIBIT B

CLTA Form 110.5—Modification of Mortgage*

ENDORSEMENT

Attached to Policy No. _____

Issued By

_____ Title Insurance Company

The Company hereby insures the owner of the indebtedness secured by the insured mortgage against loss or damage which the insured shall sustain by reason of:

1. The failure of that certain agreement executed by _____ and recorded _____ to modify the insured mortgage or the obligation secured thereby;
2. The priority of any lien or encumbrance over the lien of the insured mortgage as modified by the above mentioned agreement, except for those matters shown in Schedule B as prior to the insured mortgage, and the following matters:

This endorsement is made a part of the policy and is subject to all of the terms and provisions thereof and of any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

Date: _____

_____ Title Insurance Company

By: _____
Authorized Signatory

CLTA Form 110.5 (Rev. 6-14-96)

ALTA—Lender

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EXHIBIT C

ENDORSEMENT

Attached to Policy No. _____

Issued By

_____ Title Insurance Company

This Company hereby insures the owner of the indebtedness secured by the mortgage referred to in Schedule A against loss or damage sustained by the Insured by reason of the extension of the maturity date of the obligation secured by the Mortgage from _____ to _____ and including _____ by agreement dated _____ impairing the lien of the insured mortgage on the land or its priority.

This endorsement is made a part of the Policy and is subject to all the terms and provisions thereof and of any prior endorsement thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and prior endorsements, if any, nor does it extend the effective date of the Policy and prior endorsements or increase the face amount thereof.

Date: _____

_____ Title Insurance Company

By: _____
Authorized Signatory

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Extension of Maturity Date

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Creative Solutions

Creative Solutions is a bi-monthly feature. Send your questions or comments to the Editor-In-Chief at smcevely@icsc.org.

AVOIDING A GROUND LEASE FAUX PAS: Title Insurance Is Worthwhile for Ground Lessors as Well as Lessees

MICHAEL ZERMAN

Many landlords and tenants entering into long-term ground leases fail to provide for the sort of title insurance contingencies that are customarily found in purchase and sale transactions. This omission may lead to disastrous consequences for the landlord as well as the tenant. Problems are most likely to arise when a landowner leases a portion of a larger parcel to a tenant under a long-term ground lease. This situation can occur with any property type, including office and industrial buildings, hospitals, and apartments, but it most commonly arises when a retail tenant leases a parcel within a large shopping center or mixed-use development.

Listed below are some examples of title defects arising from ground lease transactions that Manatt, Phelps & Phillips, LLP, attorneys have encountered in recent years.

Illegal Subdivisions: California law prohibits the division of a legal lot into smaller parcels through a sale, lease or financing without government approval. Violators are subject to criminal prosecution and fines. Government authorities may also withhold building permits, void an executed lease and record notices of violation against the property. Interior space leases are exempt from California's subdivision law. Other exemptions apply to the construction of commercial or industrial buildings on leased land, in certain instances. However, such exemptions do not apply to every configuration of land leased for commercial or industrial use, and are not applicable to any residential developments. Additionally, even if a ground lease is initially exempt from the subdivision laws, a purchase

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Letters of Credit: No Panacea for Tenant Defaults

JO-ANN M. MARZULLO

Posternak Blankstein & Lund LLP
Boston, MA

Once a landlord decides to lease space to a prospective tenant, subject to receiving some security for tenant performance, what type of security must be considered in order for that landlord to receive and retain the bargained-for return on investment? Since a defaulting tenant is also a likely candidate for a voluntary or involuntary filing for bankruptcy protection, the Bankruptcy Code must be considered from the outset in structuring the deal and security accepted. Letters of credit have been tried as an alternative to cash security deposits to give landlords more protection than they would have had under the Bankruptcy Code with cash security deposits. Unfortunately, in some recent bankruptcy cases, the bankruptcy courts have not treated letters of credit differently from cash security deposits.

Security deposits held by a landlord are property of the debtor under the Bankruptcy Code § 541, and a landlord's damages for rejection of real property leases are limited pursuant to Bankruptcy Code § 502(b)(6). A large security deposit posted by a bankrupt tenant, which exceeds the maximum claim allowed under the Bankruptcy Code, will result in the landlord's being forced to turn over to the bankruptcy estate the portion of the security deposit in excess of the allowed claim. Or, as "cash collateral" the bankruptcy estate may be able to reclaim the deposit under Bankruptcy Code § 542.

Bankruptcy Code § 502(b)(6) does not permit a landlord to assert a lease rejection claim in excess of:

- (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of —
 - (i) the date of the filing of the petition; and
 - (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
- (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

A letter of credit held in lieu of a cash security deposit by the tenant, such as when a lease allows a tenant to post either cash or a letter of credit as the security deposit, is likely to be held limited by the § 502(b)(6) limitation. *In re PPJ Enterprises (U.S.), Inc.*, 324 F.3d 197 (3d Cir. 2003). In another recent case, the "independence principle" set forth below won the landlord the right to draw on the letter of credit, but not to keep all of the proceeds. *In re Stonebridge Technologies, Inc.*, 291 B.R. 63 (Bkrptcy N.D.Tex. 2003). The bankruptcy judge in *Stonebridge* upheld the independence principle by stating that neither the letters of credit nor the proceeds therefrom are property of the debtor's estate. This is because letters of credit are generally subject to the "independence principle."

The independence principle provides that a beneficiary need only take the required steps to draw on a letter of credit, regardless of any disputes between the beneficiary and the issuer's applicant. The court in *Stonebridge* held that the independence principle protected the draw on the letter of credit. However, because the lease

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Creative Solutions

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option in the lease could trigger a violation at a future date.

CC&Rs With Power of Termination: CC&Rs are promises to maintain real property in accordance with certain conditions that have been specified in prior deeds or other recorded documents. Some CC&Rs provide that a violation thereof will result in the reversion of the real property to the original grantor. For example, property donated to a charitable institution may contain a restriction in the original deed which provides that the property will revert to the grantor if it ever ceases to be used for the original charitable purpose. A charitable organization may unwittingly violate such restriction if it ground-leases property to a for-profit enterprise.

Lot Line Adjustments/Overlapping Ground Leases: In certain instances, a property owner may enter into multiple ground leases and/or purchase options with affiliated entities affecting adjacent legal parcels within a single development. Subsequently, the owner may reconfigure legal parcels by lot line adjustment in order to facilitate development of the site. In such cases, the owner must also amend any recorded memoranda of lease to reflect the revised

legal description of the parcels. Failure to do so may result in leasehold parcels that straddle lot lines in violation of subdivision laws, and may also create overlapping leasehold interests in the same land.

Frequently, the ground lessee or its lender will identify these issues if they perform their own title review analysis. However, if the lessee elects not to obtain title insurance, or does not yet have leasehold financing in place when it enters into the ground lease, these issues may remain undiscovered for months or years.

Property owners may incur substantial legal costs to correct these problems if they are not addressed prior to execution of a ground lease and recording of a memorandum of such lease. Therefore, it may be worthwhile for the ground lessor to obtain its own title insurance policy for the ground leased parcel, whether or not the ground lessee obtains leasehold title insurance. Such title insurance policy should include appropriate endorsements that insure the owner/lessor against any loss arising from the violation of any CC&Rs or subdivision laws, or from the failure of the leasehold estate to vest in the ground lessee.

This is not common practice today, because most ground lessors will have previously obtained an owner's title insurance policy upon acquiring the land, and seek to avoid additional costs. However, an owner is not insured against damages resulting from its own acts subsequent to the date of the original policy. In addition, the

value of land usually increases substantially upon entering into a long-term ground lease for such land, and it may be advisable for the owner to obtain new title insurance that reflects this increased value. Moreover, a long-term ground lease is comparable to a conveyance of real property where the seller finances 100% of the purchase price with a purchase money mortgage that fully amortizes over 30 years or more. In the latter scenario, most sellers would require a lender's title insurance policy insuring the seller/lender that title to the encumbered property is vested in the buyer/borrower, and that the seller/lender has a valid lien, subject only to approved title exceptions. Characterization of the transaction as a ground lease rather than a financing should have no effect on the owner's willingness to assume such title risks. Therefore, most ground lessors should seriously consider obtaining the type of title insurance described above when entering into ground lease transactions.

Attorney Contact:

MICHAEL J. ZERMAN
A Professional Corporation
Manatt, Phelps & Phillips, LLP
11355 W. Olympic Blvd.
Los Angeles, CA 90064

Tel: (310) 312-4310
Fax: (310) 996-6942
E-mail: mzerman@manatt.com

Proposed Revisions

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although the revised ADAAG could impose new requirements on exactly what constitutes the suitable removal of a barrier.

Under the current ADAAG, public accommodations include retail stores, hotels, bars and restaurants, movie theaters, public transportation terminals, museums, parks and zoos, public schools, etc. These buildings are required to be accessible to the disabled public to the same extent they are accessible to the non-disabled public. To the extent that they are not accessible to disabled persons, they are vulnerable to federal discrimination claims. Retail stores and fast food restaurants across the country, especially in Florida, have been hit particularly hard by ADA activist organizations and plaintiffs' attorneys who have filed hundreds of lawsuits under the ADA, known in the legal community as "drive-by" lawsuits. The

ADA's regulations do not currently require that advance notice be given to a potential defendant before filing a lawsuit. In resolving many cases, defendants must pay the plaintiffs' attorney fees, in addition to bearing the cost of the alterations. The extent to which the proposed ADAAG, when finally adopted, will impose additional burdens in resolving such litigation is unknown.

In commercial facilities such as office buildings, factories and warehouses, generally only those areas that are open to the public, such as lobbies and some common areas, as well as entry and egress to and from work areas, are required to be fully accessible under the current ADA and ADAAG's specifications. However, there is some indication that the proposed ADAAG may expand the requirements in these types of buildings with respect to new construction and alterations. Mixed-use public accommodations/commercial facilities are generally required to be fully accessible to the disabled public to the extent that the public

accommodation and commercial facility portions of the properties standing alone are required to be accessible.

The question that remains — and requires careful analysis — is the extent, if any, to which existing public accommodations and commercial facilities that comply with the current ADAAG, but may not comply with the ADAAG finally adopted by the DOJ, will be required to remove barriers to disabled persons. Until the current ADAAG and the final ADAAG are fully compared and analyzed, the impact of the substantive changes on public accommodations and commercial facilities will not be clear, and the impact these changes will have on landlord-tenant relations must also be studied. ■

GARY COLE is an associate at Seyfarth Shaw's Chicago office, as well as a licensed architect and a member of AIA.

IRA FIERSTEIN is a partner at the firm's Chicago office.



California Licensing Requirements for Unregulated Lenders and Intermediaries

Michael J. Zerman



Michael J. Zerman

Michael Zerman is a Partner at Zuber Lawler & Del Duca LLP in Los Angeles. His practice concentrates on real estate lending, leasing, and purchase and sale transactions for public and private companies, financial institutions, pension funds, and government entities.

I. Introduction

For much of the last century, real estate lenders were most often regulated financial institutions, such as commercial banks, savings and loan associations, and insurance companies, or regulated pension funds, which held exempt status under California's lender and broker licensing laws. Intermediaries, who introduced borrowers to lenders and helped to negotiate the loan terms, were called brokers, and they understood that real estate licenses were required to conduct their trade. Today the roles assigned to those engaged in real estate lending contain many grey areas. For example, private lenders and crowdfunding enterprises frequently create a new entity in order to lend funds on a transaction or a pool of transactions, and then create another entity to receive an origination fee or to service the loan(s).

II. The California Finance Lenders Law

The California Finance Lenders Law¹ governs lenders and brokers engaged in the business of making or negotiating "consumer loans" or "commercial loans."

Consumer loans are defined to include most loans where the borrower uses the proceeds for personal, family, or household purposes.² Commercial loans are defined to include most loans for amounts greater than \$5,000, whether secured or unsecured, where the borrower does not use the proceeds for personal, family, or household purposes.³ No person may participate as a lender or broker of consumer loans or commercial loans in California without obtaining a license from the California Commissioner of Business Oversight.⁴ Out-of-state lenders that make loans to California residents must be licensed in California as finance lenders.⁵ The process to obtain a license can take between six to twelve months or longer. Anyone who willfully violates the Finance Lenders Law may face fines of up to \$10,000 and/or imprisonment for a one-year term.⁶

A. Exemptions

The California Finance Lenders Law provides that certain entities, persons, and transactions are exempt from the general licensing requirements. Exempt categories include:

1. banks, savings and loan associations, credit unions, certain SBA-approved lenders, and pawnbrokers regulated by the laws of any state or by federal law;⁷
2. licensed check cashers;⁸
3. colleges and universities making student loans;⁹
4. securities broker-dealers licensed under California law;¹⁰

5. persons or entities who make no more than five (5) commercial loans in a twelve-month period, and the loans are “incidental” to the primary business of the person relying on the exemption;¹¹
6. certain public entities (including municipal corporations and government agencies);¹²
7. agricultural cooperatives;¹³
8. certain credit card issuers;¹⁴
9. loans made or arranged by California-licensed real estate brokers and secured by a lien on real property;¹⁵
10. cemetery brokers;¹⁶
11. licensed “residential mortgage lenders;”¹⁷
12. commercial bridge loans made by a venture capital company to an operating company;¹⁸
13. franchise loans made by a franchisor to a franchisee;¹⁹ and
14. certain commercial loans and other investments made by certain tax-exempt organizations.²⁰

B. Limitations of Exemptions

Many lenders do not fit neatly into any of the foregoing exempt categories. For example, an investment banking firm may be an exempt securities dealer under the Finance Lenders Law, but the applicable exemption would not extend to a single-purpose entity that the investment bank forms to fund one or more specific loans. A crowdfunding enterprise could claim an exemption if it does not make more than five commercial loans in a twelve-month period, but only if its lending activities are incidental to its primary business. Therefore, its primary business cannot be real estate lending. Furthermore, this exemption probably would not apply if such loans were funded by a single-purpose entity that has no other primary business.

In the absence of any exemptions, unlicensed entities or persons risk being fined and/or imprisoned for non-compliance with the Finance Lenders Law. When faced with this dilemma, many lenders first seek to obtain a license under either the Finance Lenders Law or the California Real Estate Regulations (as discussed in Section III), because each statute contains an exemption for licensees under the other statute.

C. Application Requirements

The application fee for a California Finance Lender’s license is a total of \$300, which is non-refundable.²¹ The applicant must file an application with the Department of Business Oversight, which contains responses to eleven multi-part questions and thirteen exhibits with information about the applicant,²² including financial statements prepared according to generally accepted accounting principles that demonstrate a net worth in excess of \$25,000.²³ The application’s “Execution Section” requires applicants to make thirty-three declarations about the applicant’s business operations under penalty of perjury.²⁴ After an application is submitted, the Commissioner of Business Oversight investigates the applicant’s principal officers, directors, and any persons who own or control more than ten percent of the applicant, to determine whether any of them have committed a crime or fraudulent act within the past ten years.²⁵ If an entity owns or controls more than ten percent of the applicant, then additional questionnaires and fingerprints must be submitted for each officer, director, general partner, or managing member of the owning or controlling entity.²⁶ However, the Commissioner of Business Oversight may waive this requirement if the Department determines that further investigation is not necessary for public protection.²⁷

Applicants must file a \$25,000 surety bond with the Commissioner of Business Oversight together with the other application materials.²⁸ This surety bond must be maintained at all times after the license is issued.²⁹ Licensees that operate from more than one business location must apply for an additional branch office license for each location,³⁰ but only one surety bond is required for all locations.³¹

Licensees must preserve their books, accounts, and records for at least three years for inspection by the Commissioner of Business Oversight.³² Any licensee located outside of California must also agree to make its books, accounts, papers, records, and files available to the Commissioner of Business Oversight at a designated location in California within ten days after any request by the Commissioner, or to pay the reasonable travel expenses, meals, and lodging incurred by the Commissioner or its representatives during any investigation or examination made at the licensee’s location outside of California.³³ Licensees are also subject to certain restrictions on advertising,³⁴ and all advertisements (whether printed or oral) must include the license under which the loan would be made or arranged.³⁵

Once approved, a finance lender's license remains in effect indefinitely until it is surrendered, revoked, or suspended.³⁶

D. Limitations on Licensees

Holding a finance lender's license may not accomplish all of the objectives that the licensee intended. A finance lender's license only allows a lender to make consumer or commercial loans, or a broker to negotiate and perform other broker services *in connection with loans made by other finance lenders*.³⁷ A finance lender's license does not entitle the licensee to perform broker services for most regulated financial institutions because although banks, savings and loan associations, and licensed broker-dealers are *exempt* from the Finance Lenders Law, they are not deemed to be *licensed* entities. Further, a finance lender's license does not entitle the licensee to perform broker services for unregulated lenders or borrowers that do not possess a finance lender's license, including any affiliated entities that are unlicensed. Therefore, even if one entity is a licensed finance lender, it will be unable to accept broker commissions from an affiliated fund that is not a licensed finance lender. These limitations present a problem for many private loan funds, which typically form separate legal entities for each fund.

Moreover, a licensed finance lender may not sell promissory notes evidencing any loans made by the licensee or purchased from another licensee, except to certain "institutional investors," which includes government agencies, regulated banks and insurance companies, large pension funds, public corporations, and other finance lenders.³⁸ The Finance Lenders Law generally precludes licensees from selling notes to affiliated entities or funds that are not licensed finance lenders.³⁹ Therefore, private loan funds cannot originate loans through a licensed entity and then sell such loans to an affiliated entity that is unlicensed. Instead, most private loan funds must obtain a separate finance lender's license for each fund, even though the application process can take six to twelve months (or longer) for each license.

III. The California Real Estate Regulations

In order to lawfully engage in real estate broker activities, most lenders, whether licensed, unlicensed, or exempt under the California Finance Lenders Law, must comply with the California Real Estate Regulations ("Regulations").⁴⁰ The Regulations provide that it is unlawful for any person to engage in the business of, act in the capacity of, advertise as or assume to act as a "real estate broker" or a "real estate salesperson" within the State of California without first obtaining a real estate license from the California Bureau

of Real Estate.⁴¹ Anyone who fails to comply with these regulations could be imprisoned for a six-month term and/or be punished by a fine of up to \$60,000, in addition to having his, her, or its real estate license suspended or revoked.⁴²

The statute defines a "real estate broker" to include any person who "... for compensation or in expectation of compensation, regardless of the form or time of payment ... solicits borrowers or lenders or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in connection with loans secured directly or collaterally by liens on real property or on a business opportunity ..."⁴³ or "... engages as a principal in the business of making loans or buying from, selling to, or exchanging with the public ... notes secured directly or collaterally by liens on real property...."⁴⁴

A real estate salesperson is defined as "a natural person who, for compensation or in expectation of compensation, is employed by a licensed real estate broker to do one or more of the acts ... [requiring a broker's license]."⁴⁵

A. Corporate Broker Licenses and Their Limitations

The Regulations permit a corporation to be licensed as a real estate broker.⁴⁶ However, if the licensee is a corporation, the license entitles only *one* officer thereof to engage in the business of real estate brokering on behalf of the corporation.⁴⁷ This officer must be designated in the corporation's application for a license.⁴⁸ If a licensed corporation desires any of its officers other than the designated officer to act as a real estate broker under the corporation's license, then the corporation must procure an additional license for each of such additional officers.⁴⁹

A real estate license entitles only one designated corporate officer to solicit borrowers or lenders, negotiate loans, or service loans for third parties. Although the Regulations make an exception for clerical workers,⁵⁰ any other employees or officers who solicit borrowers or lenders, or negotiate the terms of loans, or service loans, must do so under separate licenses, either as a real estate broker or a real estate salesperson. In the absence of any exemptions, this requirement would impose great administrative burdens on many lending institutions, where multiple employees perform broker-related activities, often in several states. A corporation may obtain additional real estate broker licenses, but for each license an officer of the corporation must pass a written examination in the same manner as if applying for an individual broker's license.⁵¹ In contrast to a real estate broker, a real estate salesperson must be a

natural person. Therefore, a corporation cannot obtain a salesperson's license on behalf of its employees. In addition, the Regulations require a licensed real estate broker to procure an additional license for each separate place of business within the State of California.⁵² Ordinarily, a real estate license may only be used in the single location that is designated in the license.⁵³ Therefore, a licensed broker must obtain additional real estate licenses for each branch location where broker services are offered, even if the branches are located in the same city or county.

B. Exemptions

Without any exemptions, the licensing provisions of the Regulations would impose a great administrative burden upon many large financial institutions. However, the Regulations exempt certain entities or persons from the general licensing requirements, including the following:

1. banks, savings and loan associations, pension trusts, insurance companies and credit unions regulated by the laws of any state or by federal law, and their employees;
2. agricultural cooperatives and regulated agricultural loan companies;
3. licensed attorneys when rendering legal services to a client;
4. licensed finance lenders acting under the authority of a finance lender's license;
5. cemetery authorities;
6. persons authorized by a savings institution to act as an agent of that institution, when acting under the scope of that authorization;
7. licensed securities brokers and securities dealers, and their employees, in connection with the purchase and sale of mortgage-backed securities; and
8. licensed "residential mortgage lenders" acting under the authority of that license.⁵⁴

C. Limitations of Exemptions

Many lenders and intermediaries do not fit neatly into any of the exempt categories listed above. For example, securities dealers are only exempt in the limited context of the sale of mortgage-backed securities. Moreover, this limited exemption would not extend to a separate entity that a securities dealer creates to fund one or more specific loans,

or to receive origination fees on those loans. As discussed in Section II.D. above, the exemption for a licensed finance lender does not allow a finance lender to perform most real estate broker services, other than those services performed in connection with a loan made by another finance lender.⁵⁵

D. Exception for Finders and Middlemen

There is an exception to the broker license requirements for the payment of compensation to a mere "finder" or "middleman." A person who merely introduces a prospective borrower or lender is not performing an activity that requires a license. This "finder" is not considered to be acting as the agent for either party to a transaction as long as the finder does not participate in the loan negotiations in any way, not even incidentally. An agreement to compensate a finder as consideration for facilitating an introduction is enforceable by the finder regardless of whether the finder is licensed.⁵⁶ This exception does not apply if the finder performs any act that would require a license, regardless of how minor or incidental the act may be.⁵⁷ A broker or salesperson who pays a "finder's fee" to a non-licensee, or to a salesperson who is not employed by the broker paying the fee, would violate the Regulations if the alleged finder performed *any* act requiring a real estate license.⁵⁸ Actions that may require a license include participating in loan negotiations, showing properties to lenders, or assisting a borrower in preparing a loan application.⁵⁹ A licensee is always at risk when paying any fee or compensation to a person who does not hold a license due to the difficulty in determining whether the recipient has crossed the narrow line between a finder and an agent.

E. Out-of-State Brokers

A licensed California real estate broker may pay a commission to a broker licensed in another state.⁶⁰ Whether an out-of-state broker, who is not licensed in California, can recover a commission in a California court is not determined by the location of the real property, but by the location in which the broker performed the services that require a license. A California license is only required when an out-of-state broker performs activities within California that require a license, such as meeting with potential lenders or borrowers within California in order to solicit business or negotiate loan terms, showing real property within the state to prospective lenders, or inspecting California properties on behalf of a lender or borrower.⁶¹ When an out-of-state broker performs these types of acts in California, he cannot recover compensation.⁶² However, even when the borrower, lender, or real property is located within California, if the out-of-state broker does not perform any act within

California that requires a license, then he can recover a commission for services performed outside of California, as long as he held the appropriate license in the state where he performed the services.⁶³

Despite the foregoing exceptions, an out-of-state broker must still comply with the California Finance Lenders Law if the broker makes loans to California residents.⁶⁴ The exemption under that law for licensed real estate brokers only applies to California licensees.⁶⁵

IV. Conclusion

Due to the complexity of California's lender and broker licensing requirements, most unregulated lenders should understand these licensing rules before engaging in real estate lending or intermediary activities within the state.

Endnotes

- 1 Cal. Fin. Code §§ 22000–780.
- 2 *Id.* §§ 22203, 22204.
- 3 *Id.* § 22502.
- 4 *Id.* § 22100. Certain additional rules apply to licensees engaged in the business of making or brokering residential mortgage loans. *See id.* §§ 22100(b), 22100(e). However, this article will focus solely on the origination and brokerage of loans secured by commercial real estate.
- 5 *People v. Fairfax Family Fund, Inc.*, 235 Cal. App. 2d 881 (1964).
- 6 Cal. Fin. Code §§ 22753, 22780.
- 7 *Id.* § 22050(a).
- 8 *Id.* § 22050(b).
- 9 *Id.* § 22050(c).
- 10 *Id.* § 22050(d).
- 11 *Id.* § 22050(e).
- 12 Cal. Fin. Code § 22050(f).
- 13 *Id.* § 22051.
- 14 *Id.* § 22052.
- 15 *Id.* § 22057.
- 16 *Id.* § 22058.
- 17 *Id.* § 22060.
- 18 Cal. Fin. Code § 22062.
- 19 *Id.* § 22063.
- 20 *Id.* § 22064.
- 21 *Id.* § 22103.
- 22 Cal. Code Regs. tit. 10, § 1422.
- 23 Cal. Fin. Code § 22104. All licensees must maintain this \$25,000 net worth at all times. *See id.* § 22104(a). Licensees that arrange, but do not make, residential mortgage loans must maintain a net worth of at least \$50,000.

See id. § 22104(c). Licensees that make residential mortgage loans must maintain a net worth of at least \$250,000. *See id.* § 22104(b).

- 24 Cal. Code Regs. tit. 10, § 1422, execution sec.
- 25 Cal. Fin. Code §§ 22105, 22109.
- 26 Cal. Code Regs. tit. 10, § 1422, exhibit C.
- 27 *Id.*
- 28 *Id.* at exhibit B.
- 29 Cal. Fin. Code § 22112.
- 30 *Id.* §§ 22102, 22152.
- 31 *Id.* § 22112.
- 32 *Id.* §§ 22156, 22157; Cal. Code Regs. tit. 10, § 1425.
- 33 Cal. Code Regs. tit. 10, § 1422 execution sec. subdiv. 26.
- 34 Cal. Fin. Code §§ 22161, 22162, 22165, 22166.
- 35 *Id.* § 22162.
- 36 *Id.* § 22700(a).
- 37 *Id.* §§ 22004, 22059.
- 38 *Id.* § 22600.
- 39 *Id.*
- 40 Cal. Bus. & Prof. Code § 10130–249.93.
- 41 *Id.* § 10130.
- 42 *Id.* §§ 10138, 10139, 10165.
- 43 *Id.* § 10131.
- 44 *Id.* § 10131.1.
- 45 *Id.* § 10132.
- 46 Cal. Bus. & Prof. Code §§ 10006, 10150(b), 10211.
- 47 *Id.* § 10211.
- 48 *Id.*
- 49 *Id.* § 10158.
- 50 *Id.* § 10133.2.
- 51 *Id.* §§ 10153, 10150.
- 52 Cal. Bus. & Prof. Code § 10163.
- 53 *Id.* § 10162.
- 54 *Id.* § 10133.1(a).
- 55 Cal. Fin. Code §§ 22004, 22059.
- 56 *Tyrone v. Kelley*, 9 Cal. 3d 1 (1973); *Queen of Angels Hosp. v. Younger*, 66 Cal. App. 3d 359 (1977).
- 57 *Tyrone*, 9 Cal. 3d at 9; *McConnell v. Cowan*, 44 Cal. 2d 805, 811 (1955).
- 58 Cal. Bus. & Prof. Code § 10138.
- 59 *Id.* § 10131.
- 60 *Id.* § 10137.
- 61 *Id.* § 10131.
- 62 *Consul Ltd. v. Solide Enters., Inc.*, 802 F.2d 1143, 1149 (9th Cir. 1986).
- 63 *Id.* at 1149–51.
- 64 *People v. Fairfax Family Fund, Inc.*, 235 Cal. App. 2d 881 (1964).
- 65 Cal. Fin. Code § 22057.