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COMPLEX COMMERCIAL TRANSACTIONS AND SOLUTIONS

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Below are certain selected issues that effect strategies related to loan workouts on mixed collateral transactions. Since the economy has created financial problems and borrower defaults, Special Asset Departments are supervising loan workouts, modifications and commercial litigation now on the rise. Please note that I have addressed only selected issues and remedies in a very complex area of law.

I. Foreclosure

A creditor can non-judicially foreclose against its real property collateral without initiating litigation. California Code of Civil Procedure Section 580(d), however, precludes the creditor from obtaining a deficiency judgment from a non-judicial foreclosure sale. The anti-deficiency rule does not apply to a junior lienholder that has had its security interest extinguished by a non-judicial foreclosure of a senior lienholder. Further, a junior lienholder who bids and acquires the subject real property collateral at the non-judicial foreclosure sale of a senior lienholder may be required to apply to the court for a determination of the fair value of the acquired interest and to provide the debtor a credit against its obligations for that fair value to preserve its rights to a deficiency judgment. For a non-judicial foreclosure, the creditor will use a foreclosure trustee to conduct the sale. The foreclosure trustee will obtain a trustee's sale guaranty from a title insurer to protect the creditor from any claimed defects with the sale procedure.

California Code of Civil Procedure Section 726(a) provides that a creditor may bring only one lawsuit for the recovery of a particular debt which is secured by a deed of trust on real property. Thus, the filing of a lawsuit which does not include a cause of action for judicial foreclosure upon the creditor's real property collateral may be deemed a waiver of the creditor's rights to that collateral. California Code of Civil Procedure Section 726(b) enables a creditor to file a lawsuit seeking a judgment that the encumbered real property be sold at a foreclosure sale. In such a lawsuit, the creditor may obtain a deficiency judgment against the debtor unless otherwise prohibited by law. The resulting judgment orders that the encumbered real property be sold at a foreclosure sale, that the proceeds of the sale be applied to the secured debt, and that judgment be entered against the debtor for any deficiency.

A debtor is entitled to credit for the fair value for the sold real property. Unlike a non-judicial foreclosure, the debtor has one year if a deficiency remains, and three months in the absence of a deficiency, to repurchase the real property for the sale amount plus costs and interest. This is commonly referred to as the "right of redemption."

A guaranty is very common in a commercial credit transaction. Based upon the guaranty form that the guarantor has executed, a creditor may be able to sue a guarantor first without proceeding against the borrower or the collateral. If the guarantor satisfies the debtor's obligations to the creditor, then the creditor's rights

against the debtor will be subrogated to the guarantor. Typically, the creditor will pursue all parties in one lawsuit to avoid anti-deficiency benefits to the guarantor.

A judicial foreclosure preserves the right to a deficiency judgment against the debtor and guarantors may be joined as defendants in the same lawsuit. However, non-judicial foreclosures are quicker, less expensive and the debtor does not have a right of redemption. A secured creditor may commence a non-judicial foreclosure under its power of sale and file a lawsuit for judicial foreclosure simultaneously. The creditor does not need to make an election until one of the proceedings is completed.

II. Personal Property Security

Article 9 of the California Commercial Code (“Article 9”) governs the enforcement against certain personal property collateral. The sale of collateral under Article 9 may be either by private or public sale. General notice requirements include sending a notice to all persons liable on the obligation or known to the creditor as having a claimed security interest in the collateral. The failure to give proper notice may result in the loss of the right of the creditor to a deficiency judgment. The sale also must be conducted in a commercially reasonable manner. A security interest in stock, deposits accounts, intellectual property and other forms of personal property collateral are governed by other UCC provisions, other state law and federal law as to copyrights, patents and trademarks.

A creditor risks waiving the right to a deficiency judgment when enforcing against the collateral of a debt which is secured by both real and personal property. To preserve the right to a deficiency judgment, the creditor may simultaneously foreclose against the personal property and real property collateral in a unified sale, or foreclose against the personal property collateral first. As noted above, the causes of action applicable are always combined in one lawsuit.

III. Preliminary Attachment Orders and Writs

A Right to Attach Order (“RTAO”) is governed by CCP Section 48.1.010, et seq. where the creditor can have a writ of attachment issued and then levied upon certain of the debtor’s assets. The availability and procedures for levy depend on the nature of the property to be attached, including but not limited to, the following items:

A. Equipment of an Ongoing Business: The creditor files a notice of attachment with the Secretary of State.

B. Personal Property: The creditor generally has a levying officer take possession of the debtor’s tangible personal property.

C. Real Property: The creditor records a writ of attachment in the official records of a county in which the debtor’s real property is located;

D. Motor Vehicles: The creditor files a notice of lien with the Department of Motor Vehicles.

E. Business Revenues: The creditor submits the writ of attachment with instructions and levy fees to the office of the sheriff, which then places a keeper at the debtor’s place of business to take custody of the debtor’s business inventory and to collect the debtor’s generated revenues up to the amount of the writ of attachment.

F. Deposit Accounts: The creditor submits the writ of attachment, with instructions and levy fees to a levying officer (often a sheriff, marshal, or registered process server), who then serves a financial institution with the writ of attachment. The financial institution is then obligated to turn over the levied funds.

G. IRS Refunds. There are specific procedures for the creditor to take an assignment of IRS refunds.

A secured creditor entitled to possession of specific property that has been pledged by a debtor as collateral pursuant to a security agreement may obtain a writ of possession if the debtor refuses to turn over that collateral. A writ of possession allows a creditor to recover possession of specific property, as compared to a writ of attachment which attaches a lien on such property.

The procedures for obtaining a writ of possession are governed by the California Code of Civil Procedure, commencing at Section 511.010. Following the filing of a lawsuit, a creditor can apply to the court either on a noticed or ex parte basis for a writ of possession. To obtain a writ of possession, a creditor must show its right to possession and the debtor's wrongful detention of the property. To obtain a writ of possession on an ex parte basis, the general standard is that the creditor must show that the property was acquired in the debtor's ordinary course of business and there exists an immediate danger that the property will become unavailable for levy or substantially impaired in value. The creditor may also seek a temporary restraining order to prevent the debtor from concealing or transferring the property pending the hearing on its application for a writ of possession.

Following issuance of a writ of possession, the creditor must post a bond for twice the value of the debtor's interest in the specific property. The court may issue an order directing the debtor to transfer possession of the property to the creditor, or directing a levying officer (usually a sheriff or marshal) to take possession of the property and to enter into private premises.

IV. Receivers

A creditor may obtain an order from the court appointing a receiver to take possession of the debtor's business, property, or both. The receiver may be used to enter the debtor's premises and protect the collateral of the creditor, including the rents and profits generated from real property. The receiver may continue to operate the collateral and secure the income generated therefrom. A receiver acts as an officer of the court and owes a fiduciary duty to both the creditor and the debtor.

The availability of the receiver in California is governed by Section 564 of the Code of Civil Procedure and the contractual agreements between the creditor and debtor. Under California law, a receiver is available if it is necessary to preserve the property or rights of a party. Following the filing of a lawsuit, the creditor may apply to the court on either a noticed or ex parte basis, the creditor must show that if a receiver is not appointed immediately, there is a substantial danger that the debtor's assets will be depleted, damaged, destroyed, or concealed before a noticed hearing can be held. If the receiver is appointed on an ex parte basis, then a hearing is set to confirm the appointment of the receiver.

In cases of suspected mismanagement or improper dissipation of collateral, a receiver will limit the debtor's access to its assets. A receiver may be the correct remedy when the debtor is in default and using the creditor's collateral to pay other debts. The receiver can take control of the debtor's business and accounts and manage them in a proper way to maximize value. In addition to the receiver's fees, receivers often employ counsel, accountants, and consultants to assist in their duties. These fees are deducted from the receivership estate. The creditor may need to advance these costs against the receivership estate, which will cause additional depletion of the debtor's reserves available to repay the loan.

V. Settlement Agreements and Enforcement of Judgments.

Upon a negotiation settlement, the settlement agreement may also contain a stipulation for entry of judgment securing a payment plan. In such an agreement, the debtor agrees to the entry of a judgment, and the creditor agrees not to take steps to enforce the judgment so long as the debtor does not default on the payment plan. This should be structured with the judgment being entered and not enforced until the debtor defaults. Entering the judgment enables the creditor to advance its position by recording and filing the judgment. One concern the debtor may express is the judgment may act as an event of default under the debtor's other obligations and may

prevent the debtor from obtaining the necessary credit to continue operations. Upon entry of the judgment, interest is limited to the post-judgment legal rate of 10% per annum. It is also important to note that if a debtor pledges a deed of trust to secure a stipulation to entry of judgment, then the creditor may be limited in its collection remedies by the one action rule discussed earlier in this article. Further, corporate entities require representation by an attorney to enter into such a stipulation, as corporations cannot appear in pro per.

A stipulation for entry of judgment should include a general release of the creditor, including Civil Code Section 1542, a waiver of the five-year requirement to bring the action to trial, and the judgment should be for the full amount of the obligation notwithstanding any compromised amount agreed upon in the payment plan. The full amount should include attorneys' fees, costs, such as appraisals and the default interest. A judgment must be renewed within every ten-year period.

A confession of judgment, which is a written admission of liability without the filing of a lawsuit is another method to obtain a judgment. Confessions of judgment are generally disfavored by courts and are subject to being set aside on the ground that the debtor did not appreciate the consequences of confessing to judgment.

As a general matter, a judgment may be executed against real property, personal property that can be manually delivered, shares of stock, debts due to the debtor, crops, checks, drafts, money orders, and interests in property from the estate of a decedent. Natural person judgment debtors have a significant number of exempt assets, which include income and assets necessary for supporting their family including the homestead exemption.

VI. Conclusion.

Each loan modification, default should be carefully calculated. A legal document audit should be accomplished by counsel to determine if any additional documents are required by borrower to the extent the creditor grants a forbearance or modification. If additional collateral is given by a borrower during the forbearance period, proper security documents should be prepared.

Actual resolution of legal issues depends upon many factors including variations of fact and state laws. This article is not intended to provide legal advice on specific subjects but rather to offer insight into legal developments and issues. Consult with legal counsel before taking action on matters covered in this article. Copyright 2008 Harriet B. Alexson. All rights reserved.