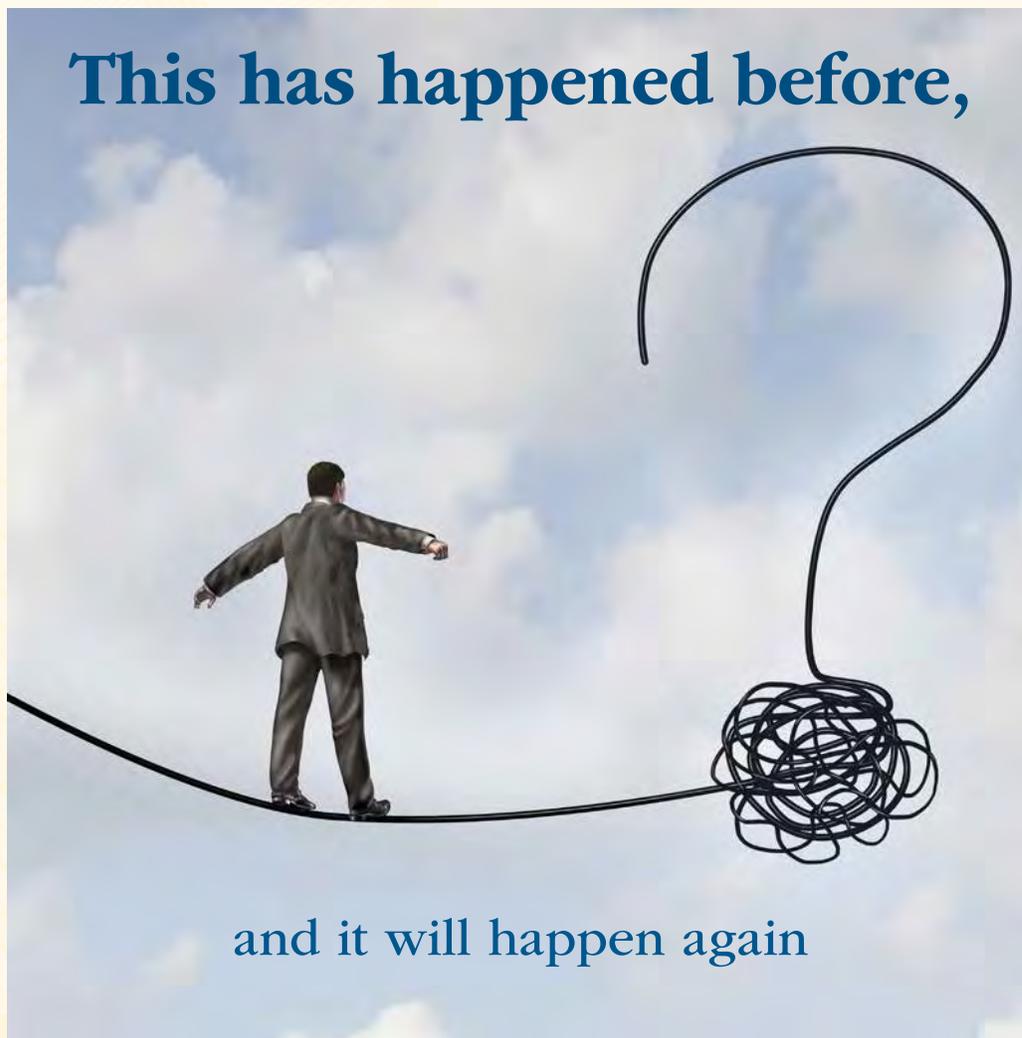


Published by the National Commercial Services Division of First American Title Insurance Company

	EB5: The Intersection of Real Estate and Immigration	3
	Limited and Conditional Guaranties	5
	Lost Certificate in a Mezzanine Transaction	8
	Asia Major Source of Cross-Border Capital	12
	Real Estate Conference Schedule	15



*By: Joshua Stein
Joshua Stein PLLC*

Construction lenders are lending again. Developers are developing again. It's great. But will they make the same mistakes they made in 2006 and 2007 all over again?

I asked my friend Bruce Davidson to walk me through some ways that construction and development loans can--and do--go wrong.

Bruce worked at a German construction lender before the financial crisis, then at the Federal Reserve Bank of New York helping to clean up the mess from that crisis, and most recently at Alvarez & Marsal, a global professional services firm with a focus on turnaround management and workouts.

Bruce told me stories of some disasters that crossed his radar screen – what caused them, what happened, and where the mistakes happened. Below is a composite of some of Bruce's stories, with identifying details disguised to protect the guilty. The sequence is familiar and worth remembering for anyone who has done this type of work for a while.

The story began with a developer who had a vision for a once-magnificent hotel in a great location far from the New York metro area. The hotel had three adjacent buildings. One was a hundred years old, a landmark.



2

Another was built in the 1930s. It looked great, but needed repairs. Another, built in the 1950s, had never looked great and needed demolition or at least major renovation. And the developer wanted to add for-sale high-end apartments out back.

Mistake #1: The project was unfocused, confused, and needed to be executed in stages – a great way for budgets to get out of control.

Mistake #2: The developer overstated its experience and qualifications. And the lender didn't ask the right questions.

The developer hired a local general contractor, who was bondable. The subcontractors delivered bonds, but the GC never actually did.

Mistake #3: Bonds help. Not getting a bond from the GC raised the risks for developer and lender.

The developer signed up a great hotel brand, complete with an extensive technical services agreement so the hotel would meet the brand's standards.

Mistake #4: That agreement gave the brand total freedom to specify everything – including architects and other vendors – with no control over costs.

The developer started tearing open walls to reconstruct one of the buildings

to modern standards.

Mistake #5 (or at Least Very Bad Luck): Harsh weather conditions and leaks meant that the buildings had suffered far more damage than anyone expected. The budget got out of control.

The developer needed more money but couldn't find more equity. The loan agreement prohibited the use of mezzanine debt. The seller of the hotel had agreed to defer some payments, so the developer eased some pressure by further deferring most of those payments, paying a small deferral fee, and giving the seller an equity pledge.

Good Move: In consenting to all that, the lender insisted on a "deeply subordinated" intercreditor agreement that gave the seller no rights at all except the right to wait for a check – maybe.

The seller's deferral wasn't enough. The developer still needed more money. The lender was willing to lend more, but wanted more information – a market study, sources and uses, an updated budget, a schedule, and an updated valuation.

Mistake #6: The developer couldn't give the lender the information it wanted. The budget kept changing. The developer stopped paying real estate and other taxes. But the lender didn't

want to give up.

The lender eventually agreed to a workout, pushing back maturity, increasing the loan, bringing taxes current, and giving the seller a little something.

Mistake #7: In retrospect, the lender probably should have started to foreclose. By doing the workout, the lender started to throw good money after bad.

The loan matured. The lender kept extending it. Values started to drop. The borrower stopped paying vendors.

Good Move: The lender finally started foreclosure and got a receiver appointed. The receiver made a huge difference, preventing the borrower from siphoning off cash. The receiver also brought some order to the chaotic construction process.

The lender took title and found an interim manager. Parts of the hotel were in great shape, easily rentable at premium prices. Others remained under construction. Revenue couldn't possibly cover operating costs.

Mistake #8: The lender shut down the hotel. This cut off all revenue but only some expenses. And it made any future reopening much more difficult than otherwise.



EB5: The Intersection of Real Estate and Immigration

By: S.H. Spencer Compton, Vice President-Special Counsel, First American Title Insurance Company, and Diane Schtenstein, Schottenstein, Schottenstein Law Firm

There are many ways for foreigners to get green cards to work in the United States and numerous paths to citizenship. The rules are intricate, the options vary depending on the applicant's national origin, and the cases tend to be fact sensitive. Unbeknownst to many, the EB-5 Visa has become an intersection of real estate and immigration. More and more foreigners, primarily Chinese nationals but also investors from Russia, France, and Egypt are attaining citizenship through the EB-5 programs, which have become the financing sources for an increasing number of real estate projects.

The EB-5 program was established in 1990 by the Immigration and Nationality Act, found at 8 U.S.C. § 1153 (b)(5), as a mechanism to encourage foreign investment in the United States and to create new jobs for U.S. workers. EB-5 stands for "employment-based 5th category," one of many categories on which to base a green card or citizenship application. Initially, the foreign applicant had to create an entirely new commercial enterprise to qualify for EB-5 status. The EB-5 program has since evolved and expanded. Today, if a non-U.S. individual invests \$1,000,000 in a business that creates or preserves ten jobs or more for U.S. workers (excluding the investor and his immediate family), and the investor's application is approved, the investor and his/her dependents will be granted conditional permanent residence. After about two years, if the foreigner can demonstrate that her investment has fulfilled each of the EB-5 job creation requirements, the conditions on the visa will expire and the applicant will be granted permanent residence. Thereafter, in five years, the applicant can file for U.S. citizenship.

Historically, approximately 10,000 EB-5 visas are allocated each year to foreigners worldwide; the program is an underutilized path to citizenship because, to date, that annual limit has never been reached. In recent years, two revisions to the law have made the



Spencer Compton

EB-5 visa process a more travelled road to citizenship. The first provides that the minimum investment amount may be reduced to \$500,000 if the investment is made in a "Targeted Employment Area". The United States Citizen & Immigration Service (the "USCIS") in essence defines Targeted Employment Area ("TEA") as either (i) a rural area, or (ii) an area experiencing unemployment of at least 150% of the national average rate. If the proposed new business location is not in a TEA, the investor may gather the relevant publicly available state or federal statistics and submit them with its petition to the USCIS to have a new TEA determination made. Increasingly, state business development groups are assisting in designating new areas as TEAs.

The other popular provision is the modification to the EB-5 program that allowed investment into Regional Centers. Initially, real estate was considered inappropriate for an EB-5 investment. After all, the construction of a million dollar property typically would be finished within two years and would not create 10 sustainable jobs. However, the modification to the EB-5 program ameliorated this concern..

A "Regional Center" is defined by the USCIS as "any economic entity, public or private, which is involved with

the promotion of economic growth, improved regional productivity, job creation and increased domestic capital investment". Investments within a Regional Center allow foreign nationals to count jobs created both directly and indirectly for purposes of meeting the 10 job creation requirement. For example, if a project is to build a hotel, those hotel jobs subsequently created can be counted as jobs created by the EB-5 construction project. This use of Regional Centers was first introduced as a pilot program in 1993, and in 2003 President Obama made it a permanent feature.

How does the process work? First, the Regional Center obtains preapproval for its selected EB-5 projects, then foreigners invest in that Regional Center. Regional Center certification arguably lends legitimacy that helps in marketing to foreign nationals. These passive investments have been likened to those in a closed end mutual fund: the Regional Center is a third party investment vehicle which pools capital from multiple EB-5 investors, then invests in various multimillion-dollar projects and charges an administrative fee for its management services. As of February, 2012, there were 218 Regional Centers, predominately in California, Florida and Washington. According to the USCIS website (uscis.gov) in early April 2014, there were 577 Regional Centers. A Regional Center being listed on the website does not indicate an endorsement by the USCIS.

The EB-5 program has been slow to evolve. In 2005, a Government Accountability Office report found that investors were not utilizing the program because of "an onerous application process; lengthy adjudication periods; and the suspension of processing on over 900 EB-5 cases—some of which date to 1995—precipitated by a change in the USCIS's interpretation of regulations regarding financial qualifications." However, in 2011, the USCIS began making a number of

An investor offered the lender more than 80 cents on the dollar for the loan.

Mistake #9: The lender demanded 82 cents on the dollar. The buyer said no. The buyer later said it was the best deal he never made.

▶ CONTINUED FROM PAGE 3

changes to the program in hopes of increasing the number of applicants. By the end of fiscal 2011, more than 3,800 EB-5 applications had been filed, compared to fewer than 800 applications in 2007. To put this in perspective, remember there are about 10,000 EB-5 visas available each year.

The demand for EB-5 money became more popular because of the ongoing recession and commercial banks' continuing hesitancy to make construction loans. In addition, Dodd Frank has put many more restrictions on bank lending, causing developers to seek alternative funding sources. Regional Centers are an attractive capital provider: they can be more flexible and offer more reasonable terms than commercial banks because their primary objective is not to make a profit but rather to safeguard principal and create jobs which lead to the issuance of the coveted visa. Although EB-5 money is used for manufacturing and other projects, real estate transactions are favored since they involve a tangible collateral asset and thus are perceived by investors as more secure. EB-5 financing has been successfully employed in the construction of numerous hotels, medical facilities, charter schools, and government infrastructure projects throughout the country. In particular, EB-5 money has been used in connection with many larger prominent New York City projects such as the Barclay Center in Brooklyn and Durst's Bank of America Project at Bryant Park. It is contemplated that EB-5 money will be involved in the development of part of the Penn Yards project.

Not surprisingly, a cottage industry has grown up around the EB-5 program as it requires numerous experts. To name a few, there are migration consultants who specialize in marketing to off-shore agents; migration agents/brokers who procure investors; immigration, corporate and real estate attorneys who structure and consummate the deals; and economists who do the job analysis and prepare the economic reports.

Although the EB-5 program has

The holder of the loan eventually sold the project – failed, closed, and dark – for 25 cents on the dollar.

This project's road to ruin was all too familiar, a combination of unwarranted optimism, lack of due diligence, and

had many good results, there also have been disappointments and fraud claims associated with the program. One such example is the Chicago Convention Center case. In February, 2013, The Securities and Exchange Commission (SEC) charged Anshoo R. Sethi with fraudulently selling over \$145 million in securities and collecting \$11 million in administrative fees from more than 250 investors, most of whom were Chinese nationals. Believing it was a way to get green cards through the EB-5 immigrant investor program, foreign investors were allegedly duped into purchasing interests in a company known as "a Chicago Convention Center" (ACCC) to finance the construction of a hotel/conference center near Chicago's O'Hare Airport. The project was to be built on a site once occupied by Sethi's family's budget hotel, where rooms cost as little as \$33 a night and there were weeds at the bottom of an empty swimming pool, according to the Chicago Tribune. In March, 2014, the United States District Court for the Northern District of Illinois Eastern Division issued the final judgment in the Securities and Exchange Commission v. A Chicago Convention Center, LLC, ("ACCC"). ACCC conducted a fraudulent offering targeting the EB-5 Immigrant Investors. The judgment included \$3.9 million civil penalties including \$1.45 million against ACCC, \$1.45 million against the regional center entity, and \$1 million against Sethi individually.

The EB-5 program has also generated controversy in the press. Critics have alleged that overseas promoters have made promises to foreign national investors that are inconsistent with the basic principles of the EB-5 program, and have further alleged that such promises may be violations of the United States securities laws. There is also concern that the USCIS is struggling to timely and properly review projects and immigrant-investor applications due in part to the numerous applications from both immigrant investors and developers alike. Still others have complained that the program

some wrong turns. The lender didn't insist on old-fashioned protective measures. The market didn't help. As today's market continues its exuberant rise, are we paving the way for more stories like this one? ◀

allows people to "buy" U.S. citizenship which is one reason the program has so many rules regarding both the source of a foreigner's funds and the determination that the required jobs have been created by the investment. In particular, critics are concerned that some developers are abusing the EB-5 program by "gerrymandering" economically-distressed pockets within highly affluent areas of the country, thereby cheapening the cost to obtain U.S. citizenship through the EB-5 program. It should be noted that other countries such as Canada have similar programs, sometimes characterized as more immigrant friendly, vying for foreign investment.

Because of the title insurance industry's concern that EB-5 transactions may raise securities law issues and other risks, it is advisable to involve your title insurer early on to make sure your particular transaction is insurable. Title insurance companies may be reluctant to hold EB-5 immigrant investor funds in their escrow accounts, whether pending USCIS approval of such investors' EB-5 applications or otherwise.

In conclusion, although some may find the EB-5 program problematic, it has been a source of funds for many valuable and important projects. Its future growth will depend to some extent on both the economic situation in the United States and overseas. Certainly, it is an example of how local real estate has gone global. Who knew real estate lawyers would have to pay attention to immigration law?

Published in both the N.Y. Real Property Law Journal and in The Practical Real Estate Lawyer.

Nothing contained in this article is to be considered as the rendering of legal advice for specific cases, and readers are responsible for obtaining advice from their own legal counsel. This article is intended for educational and informational purposes only. The views and opinions expressed herein are solely those of the authors, and do not necessarily reflect the views, opinions, or policies of First American Title Insurance Company. ◀



Limited and Conditional Guaranties: The “Burn Down” Guaranty and Other Variations*

By: John Murray, Vice President-Special Counsel, First American Title Insurance Company



INTRODUCTION

A mortgage lender is sometimes willing to limit the amount guaranteed by a third party in connection with a mortgage loan. Usually this is because the loan-to-value ratio at the commencement of the loan is sufficiently strong, or there is enough additional credit support or enhancement (e.g., additional collateral, a letter of credit, a master lease, or a defeasance arrangement), to permit only a limited or conditional guaranty of the underlying indebtedness. The lender may also be willing to condition the guarantor’s liability upon the happening of a future event. As noted by the Illinois Appellate Court

in *Lawndale Steel Company v. Appel*, 98 Ill. App. 3d 167, 170 (1981), “[a] conditional guaranty requires the happening of some contingent event before the guarantor will be liable on his guaranty,” while “[a]n absolute guaranty is an unconditional undertaking on the part of the guarantor that the person primarily obligated will pay or otherwise perform.”

There are numerous types of limited and conditional guaranties, including the following: “burn down” or “burn off” guaranties; “top” guaranties (discussed below); “springing,” “exploding” (or “vanishing”), “creeping,” and “shrinking” guaranties; percentage

guaranties; construction-completion guaranties; rental-achievement, lease-up, operating-deficit and “break even” guaranties; debt-service-coverage guaranties; dollar-limit or “maximum principal amount” guaranties; limited-time guaranties; “wrongful (or bad) acts” guaranties; “carry,” “interest and carry,” and “excess interest” guaranties (covering obligations other than repayment of the loan principal); loan-in-balance guaranties; and limited-amount liquidated-damages indemnity agreements.

Also, some types of limited guaranties may exempt or exclude certain of the guarantor’s (or guarantors’) assets or a portion of all of

the guarantor's (or guarantors') assets, from coverage under the guaranty or, conversely, permit recourse only to a specified pool or portfolio of assets owned by the guarantor(s). The nuances of each of these types of guaranties are beyond the scope of this article; however, each of these limited and conditional guaranties must be carefully drafted to avoid giving a court the opportunity to construe the limiting or conditional language against the lender and to further limit or even nullify the liability and obligations of the guarantor(s). Simple "buzz words" and phrases, such as "top X%," must be avoided. The borrower must also be careful to avoid inclusion of language in the guaranty agreement that would expand its liability beyond that which it intended; the guaranty should be drafted to accurately reflect and state the reasonable expectations of both the lender and the borrower.

A precise definition should accompany any words or phrases of limitation, and the nature and scope of the limitation should be clearly and comprehensively set forth in the guaranty agreement. The 1996 Restatement of the Law (Third) of Suretyship and Guaranty (American Law Institute) ("RESTATEMENT") provides definitions of terms commonly used in guaranty and surety agreements. It also provides guidelines for interpreting many of the terms and provisions commonly contained in such agreements. The RESTATEMENT does not have any specific definition of an "absolute" or an "unconditional" guaranty. This is probably because such language is deemed unnecessary; under § 8 of the RESTATEMENT, every guaranty is enforceable against the guarantor immediately upon default of the prime obligor unless the guaranty states otherwise, and the guaranty is effective without the obligee having to notify the guarantor of its acceptance.

Many jurisdictions construe an "absolute and unconditional" guaranty as one that is a guaranty of payment and that is effective immediately upon the prime obligor's default. This is contrasted with a guaranty of collection, which is enforceable against the guarantor only if (1) an execution of judgment against the prime obligor has been returned unsatisfied, or (2) the prime obligor is insolvent, or (3) the



Bank of America Tower

prime obligor cannot be served with process, or (4) it is otherwise apparent that payment cannot be obtained from the prime obligor. RESTATEMENT § 15(b).

'BURN DOWN' GUARANTIES: BANK OF AMERICA V. SCHULSON

As noted above, the borrower and lender (and their respective counsel) should pay special attention to the negotiation and documentation of limited and conditional guaranties, including "burn down" guaranties. For example, in *Bank of America National Trust and Savings Association v. Schulson*, 305 Ill. App. 3d 941 (1999), modified and reh'g denied (Jun. 30, 1999), reh'g denied (Sept. 9, 1999), appeal denied, 186 Ill. 2d 565 (1999), the issue involved the interpretation and enforceability of a "burn down" clause that appeared in separate but identical personal guaranties executed by the two individual owners of Lunan Family Restaurants Limited Partnership, an Illinois limited partnership ("Lunan"). The burn-down provision automatically reduced the amount due under each of the guaranties by a fixed percentage as principal payments were made on a \$13.5 million loan ("Loan") to Lunan by Bank of America ("Bank"). The Loan was secured by a mortgage recorded on October 2, 1991, as modified a First Amendment to Mortgage dated April

22, 1994 ("Mortgage"), as well as the owners' guaranties. The Mortgage covered, inter alia, Lunan's leasehold interests in four family-style chain restaurants operated under a Shoney's Inc. franchise. The appellate court reversed the holding of the trial court, which had ruled that the "burn down" clause in each of the guaranties was ambiguous and would apply to the Bank's receipt of principal payments made after Lunan's default, including proceeds from the sale of the Loan collateral in Lunan's subsequent bankruptcy proceeding.

Each of the guaranty agreements repeatedly described the guaranty as "absolute" and "unconditional," and guaranteed "full and prompt payment, when due, whether by acceleration or otherwise, of all obligations." The right of recovery under each of the guaranties, however, was expressly limited to the payment of \$3 million; as such sum might be reduced by the burn-down provision contained in each guaranty. The "burn down" clause stated that the amount of the guaranty "shall be reduced by an amount equal to 36% of any principal payments made with respect to the Liabilities." The separate guaranty agreements did not provide for joint and several liability of the guarantors.

Lunan defaulted on the Loan at the end of 1993, and Lunan and the Bank subsequently entered into an Amended and Restated Loan and Security Agreement in March 1994. As part of this Loan restructuring, the Bank was paid \$18,300 from the sale of equipment that constituted a portion of the Loan collateral. In accordance with the burn-down clause, the Bank credited this amount against the unpaid principal balance due on the Loan, reducing the guaranties by 36% of this amount. In October 1994 Lunan filed a Chapter 11 bankruptcy proceeding, which both the Bank and the guarantors agreed constituted a default that triggered the guarantors' obligations under the guaranty agreements. In September 1996, the restaurants that constituted the Bank's security for the Loan were sold free and clear of all liens pursuant to § 363 of the Bankruptcy Code, with liens to attach to the sale proceeds. The bankruptcy judge ordered that approximately \$8 million of the bankruptcy sale proceeds



be applied to reduction of the unpaid principal of the Loan.

On November 10, 1994, the Bank sent each of the guarantors a notice of Lunan's default under the Loan and demanded payment under the guaranties. On December 15, 1994, the Bank filed separate actions against each of the guarantors, seeking payment under the guaranties. The trial court later consolidated the two cases. The guarantors filed counterclaims seeking a declaration that they were each entitled to a reduction in the amount owed under the guaranties, in the amount of 36% of the amount of the proceeds received by the Bank from the bankruptcy sale of Lunan's restaurants. The counterclaims also alleged breach of contract by the Bank and a breach of the implied covenant of good faith and fair dealing (these claims were later voluntarily dismissed, without prejudice, by the guarantors). The Bank immediately moved for summary judgment, arguing that the burn-down clause applied only to principal payments made before the guarantors' obligations became due on November 10, 1994. The trial court found that the burn-down clause in each of the guaranties was "ambiguous." After reviewing the drafting history of the clause and the evidence regarding negotiation of the clause by the parties, the trial court held that the parties intended the burn down provision to apply to payments made at "any" time by Lunan, including post-default payments

received by the Bank as the result of the bankruptcy sale of Lunan's assets.

The bank argued strenuously on appeal that the trial court had erroneously construed the guaranties as guaranties of collection instead of payment. The Bank asserted that this interpretation was unjustified, because the language of the guaranties clearly provided that the Bank was entitled to collection under the guaranties immediately upon Lunan's default, notwithstanding the existence of the burn-down provisions.

The appellate court agreed with the Bank's interpretation of the guaranty agreements. After reviewing the rules of construction applicable to contracts as developed by case law, the court held that it was bound to give effect to each of the guaranty agreements as a whole, i.e., each of the provisions of the agreements must be given effect and read in light of the other provisions. The court noted the distinction between guaranties of payment (requiring immediate payment of the debt if the debtor fails to pay) and guaranties of collection (requiring payment only if all efforts to collect against the debtor have first been exhausted). The court noted that the guarantors had abandoned their initial argument that the Bank was first required to attempt collection against Lunan before seeking recovery under the guaranties (although they still insisted that they were entitled to a reduction in their obligations under the burn down

provision as the result of payments made at any time, including collection of the bankruptcy sale proceeds).

Both the Bank and the guarantors focused on the word "any" in the clause in each of the guaranty agreements that referred to "any principal payments made with respect to the liabilities." The Bank argued that the word "made" in this clause referred only to principal payments made by Lunan prior to Lunan's default and the Bank's demand for payment served on the guarantors. The guarantors, on the other hand, asserted that the word "any" meant that the burn-down provision would apply to payments made at any time, whether before or after default by Lunan and notice to the guarantors. The guarantors also argued that the definition of "liabilities" in each of the guaranties included accelerated obligations, and thus the discount provided by the burn down provision should also apply to payments made on such accelerated obligations.

The appellate court agreed with the Bank's contention that the guarantors' interpretation of the burn down clause would contradict several other clauses in the guaranties, rendering them meaningless and ineffective. In particular, the court noted, the guaranties each contained numerous references to the "absolute" and "unconditional" nature of the promises and obligations of the guarantors. The court agreed with the Bank's argument that the "absolute" and "unconditional" language would

7



Lost Certificated Interest in a Real Estate Mezzanine Transaction

By: David L. Wanetik, Esq., Chief Operating Officer, First American Title UCC Division

There is an ever increasing problem as mezzanine financing transactions from 2006 and 2007 are being reworked and the certificates representing the pledged equities cannot be found.

A "mezzanine transaction" traditionally involves the pledging of the equity that owns the real estate. The additional financing increases the financial stack which when added to the mortgage financing can bring the total to 80% or more of the transaction.

In 2007, when Moody's published its Approach to Rating Commercial Real Estate Mezzanine Loans it made the recommendation that mortgage borrower must "opt-in" to Article 8 of the UCC, and must "certIFICATE" its ownership interests as "securities" under Article 8.

The rationale was explained as follows: The mezzanine lender then can obtain priority and perfection of its security interest merely by taking control or physical delivery of the LLC or partnership certificates, and can take advantage of so-called "protected purchaser" status.

Therefore, Moody's expects that mortgage loan borrowers will irrevocably "opt-in" to Article 8 of the UCC and will certificate the partnership or LLC membership interests that will be pledged to the mezzanine lender.

In 2006 and 2007 when mezzanine financing was at its height, over 90% of the transactions included "opting-in" to Article 8 of the UCC and having the pledged equity certificated. Those certificates were taken at closing by lender's representative perfecting the lien. Possession provided the control requirement of the statute.

The certificates were endorsed in blank and were to be held by the lender throughout the life of the loan. The certificates were and are negotiable security instruments.

As these loans have matured, been assigned and sold and in some cases defaulted, the equities represented by those certificates need to be located



David Wanetik

and passed to any new secured party. Unfortunately, new lenders and their insurance companies are finding more and more situations where the certificates cannot be located. As they are negotiable, it creates a potential liability should those certificates be obtained by a third party without knowing that they had been lost or even stolen. (The views in this article are solely those of the author.)

The UCC, under Article 8, specifically addresses what needs to be done in this situation by the original secured party in order to protect any new secured party that will accept a replacement certificate.

Section 8-405, entitled Replacement of Lost, Destroyed or Wrongfully Taken Security Certificate sets forth the requirements:

(a) If an owner of a certificated security, whether in registered or bearer form, claims that the certificate has been lost, destroyed, or wrongfully taken, the issuer shall issue a new certificate if the owner:

- (1) so requests before the issuer has notice that the certificate has been acquired by a protected purchaser;
- (2) files with the issuer a sufficient indemnity bond; and
- (3) satisfies other reasonable requirements imposed by the issuer.

To overcome the potential liability

of a lost or stolen certificate surfacing after a new loan is in place using that equity as collateral, expensive options are available to the original lender/ secured party. It can obtain a bond in the amount of the original loan.

This is a very expensive product which any lender would be reluctant to pursue. It normally requires a cost of upwards of 10% of the amount in question. So on a \$100 million dollar loan, \$10 million would be required to obtain the bond.

The alternative is to offer an indemnity should the original certificate surface. Any new lender or any insurance company issuing a UCC policy insuring the transaction would require financial information from the proposed indemnitor to determine if it has sufficient financial assets should a claim arise. Considering the size of most of these mezzanine deals, considerable assets would be needed to meet this requirement.

What we have seen is that the certificates are rarely if ever lost. They are usually misplaced. They are taken at the real estate closing and with the other closing documents placed in a box and stored. The real estate closer may not realize the negotiable status of the document. We have seen situations where extensive searches have turned up certificates on the date of closing avoiding the pricey requirements dictated by the code.

It is essential that those handling the closing of mezzanine financing transactions be aware of the negotiable status of the certificates and maintain them carefully so that they are readily available in the future. If they are only stuffed away in a file without documentation to indicate their location, these lost certificates that were to provide comfort in the form of valuable collateral at the time of the original closing will be transposed into exceptionally costly mistakes when they can't be located at a later date.

Published in the *New York Law Journal* on August 21, 2012 ◀



be nullified under the guarantors' interpretation of the burn down clause. According to the court, "[w]hen a guaranty is 'absolute and unconditional,' the guaranteed party is not required to complete a foreclosure on the debtor's security before seeking payment under the guaranty" (citations omitted). *Schulson*, 714 P.2d at 26. The court also noted that in addition to the words "absolute" and "unconditional," each of the guaranties contained a provision that allowed the Bank to "resort to the undersigned . . . for payment of any of the Liabilities, whether or not the Bank . . . shall have resorted to any property securing any of the liabilities or any obligation thereunder." *Id.*

The appellate court also noted that each of the guaranties stated that the Bank was entitled to "full and prompt payment" upon default by Lunan and/or notice of default to the guarantors. According to the court, this language would also become meaningless under the guarantors' interpretation. The court found that this triggering provision would be nullified if the due date could be extended, as occurred in this case, for a period of almost two years (i.e., until the

date of distribution of the bankruptcy sale proceeds to the Bank). In support of this conclusion, the appellate court referred to its previous holding in *Telegraph Savings & Loan Association v. Guaranty Bank & Trust Company*, 67 Ill. App. 3d 790 (1978), a case in which, the court stated, "the facts are very close to those before us." The appellate court ruled in *Telegraph* that under the express terms of the guaranty the guarantors' obligations became due and owing immediately upon the borrower's default, and that only "voluntary" payments of principal – not payments received as the result of the subsequent foreclosure sale of the loan collateral - would release the guarantors from their obligations.

The appellate court in *Schulson* further ruled that payments received as the result of a sale of the loan collateral, whether through a foreclosure sale or a bankruptcy sale, did not qualify as "principal payments" under the terms of the burn-down clause. The court noted that each of the guaranties required "full and prompt payment" when Lunan's obligations became due without the Bank having to resort to the loan collateral. Therefore, according to the court, a ruling

favoring the guarantors' interpretation of the clause would make the guaranties illusory because the amount actually owed by the guarantors could never be finally determined until the loan collateral had been sold.

The appellate court also rejected the guarantors' argument that "added language" prevails over printed forms. The court noted that each of the guaranties was a typed form with no added language, and found that in any event the contested language of the burn down provision could be "harmonized" with the other guaranty provisions. Similarly, the court also rejected the guarantors' argument that the burn-down provision contained "specific" terms that should control over the "general" terms of the guaranties. The court found no evidence that the burn down provision was specific and that the other provisions referred to by the Bank were general, and held that the provisions could – and would - be construed as consistent so as to give effect to the entire agreement.

The appellate court next addressed the guarantors' assertion that the parol evidence rule should be "provisionally" considered to determine whether the



burn-down clause was ambiguous. The court acknowledged that in some circumstances, parol evidence might be provisionally introduced to determine whether a contract that appears clear on its face contains an ambiguity. The court further acknowledged that the parties had exchanged five drafts of the guaranties and that the burn-down provision had been heavily negotiated. However, the court held that the provisional consideration of parol evidence would only be applicable where required to clarify the definition of specific terms of a contract, in order to determine an ambiguity. The court found that the language in the guaranties requiring prompt and punctual payment, and allowing the Bank to seek collection from the guarantors without first resorting to the collateral, was clear and unambiguous. The court therefore refused to permit the introduction or consideration of parol evidence by the guarantors.

For all of the foregoing reasons, the appellate court ruled that the guarantors' obligations were triggered upon Lunan's default and that the burn down clause in each of the guaranties applied only with respect to principal payments made at that time. The court specifically directed the trial court "to consider only principal payments made before Lunan filed bankruptcy in calculating the offset to which defendant was entitled." *Schulson*, 714 P.2d at 28.

Finally, the appellate court addressed the guarantors' contention that because the guaranties did not provide for joint and several liability, each guarantor should only be required to pay the expenses incurred with collection of his own guaranty. The court noted that although there was no joint and several liability, each guaranty provided that the guarantor would pay "all expenses" of enforcement. Therefore, the court held that each guarantor was liable for payment of the full amount of the Bank's collection expenses, but the Bank could only collect this amount once. The court further held that the guarantors could present evidence to the trial court to show that some expenses had been incurred with respect to collection of one of the guaranties but not the other.

IMPORTANCE OF CLEAR AND PRECISE DRAFTING

As is evident from the court's holding in the *Schulson* case, supra, careful and

precise drafting is essential with respect to limited and conditional guaranties. See, e.g., *Tenet Healthsystem TGH, Inc. v. Silver*, 203 Ariz. 217, 221-22 (Ariz. App. 2002) (following appellate court's holding in *Schulson* and *Telegraph*, supra, based on similar facts and citing other cases holding similarly to these cases, and stating that "Other courts have reached the same conclusion on [guaranty] agreements similar to the ones at issue in *Schulson*, *Telegraph Savings & Loan*, and here").

In other cases where the guaranty agreement limits the guarantor's liability to a specific dollar amount or a stated percentage of the debt, courts have held that foreclosure proceeds obtained by the lender upon its foreclosure sale of the mortgaged property should be applied first to reduce the guaranteed portion of the debt, even where the lender has the option under the guaranty agreement to pursue the guarantor separately in lieu of foreclosure or "resort to any security." See, e.g., *BankEast v. Michalenoick*, 138 N.H. 367, 370-71 (N.H., 1994) (guarantor guaranteed up to \$100,000 of loan indebtedness of \$800,000 and guaranty stated it would be reduced by amount of any principal paydown on debt; parties agreed that guaranty was unconditional and lender was not required to first resort to mortgage security and that guaranty applied to first \$100,000 paid down on the loan; court held that once bank chose to foreclose and obtained total of \$635,000, reducing debt to \$129,000, guaranty was extinguished by its own terms, which stated that guarantor's liability extended only to the "first \$100,000" of indebtedness).

With respect to the liability of partners in a partnership for limited or conditional guaranties, see *TMG Life Ins. Co. v. Ashner*, 21 Kan. App. 2d 234, 244-46 (1995). In this case, the Kansas appellate court held that the guaranty executed by the borrower partnership's general partners that limited the guarantors' liability, in their individual capacity, "to an amount equal to one-third of the amount of the loan from time-to-time outstanding," did not require that value of mortgaged property transferred to the lender as a result of the borrower partnership's Chapter 11 bankruptcy proceeding be credited to the obligation created by the guaranty. But the court remanded the matter to the trial court because it also held that the valuation of the property at the time of the transfer had not been determined

by the trial court and such valuation was necessary to compute the amount of liability based on the "from time to time" language in the guaranty and which amount, once finally determined, would then be deducted from the gross amount outstanding under the loan because the lender repossessed the property before the amount of the guarantors' liability was determined and therefore fixed.

'TOP' GUARANTIES

Historically, lenders have had a difficult time drafting and enforcing guaranty language that obligated a guarantor to pay, e.g., the "top x%" of the loan amount. Such language, without more, is generally understood to mean that the guarantor is only liable for the difference between the loan balance and an amount set as a percentage of the original loan amount. This type of provision is often used by lenders to provide a "cushion" if the property decreases in value down to the base level as established by the percentage amount of the original loan for which the guarantor is liable. The guarantor generally understands that its liability at any time will be limited to no more than the percentage amount it has agreed to, and that its liability will disappear when the loan balance has been paid down to a certain amount.

However, this type of limitation on a guarantor's liability, if not carefully and clearly negotiated and drafted, may be open to a claim of ambiguity with all of the potentially negative consequences that could result from a court's recharacterization of the clause. For example, the lender may contend (which contention is usually unsuccessful and will be vehemently contested by the guarantor) that the language should be construed so that the guarantor is always liable for an amount equal to the stated percentage of the original loan amount, regardless of the actual amount of the outstanding loan balance. Alternatively, the lender may seek an interpretation of the language (which can also be expected to be hotly contested by the guarantor) that would provide for the guarantor's liability to decrease (but never end until full payment) on a sliding scale, i.e., the guarantor would remain liable throughout the term of the loan but such liability would decrease pro rata to the extent the principal balance has been paid down by the borrower.

It is crucial when utilizing this type



of guaranty to clearly define and clarify exactly what type of payments will qualify to reduce the guarantor's liability. For example, the proceeds from a foreclosure proceeding are generally applied first to the nonrecourse portion of the debt. If this were not the case, the "top" guaranty would be virtually worthless because the amount of foreclosure proceeds available would frequently be more than what would be required to satisfy the top portion of the debt. The lender generally expects a "last dollar" and not a "first dollar" guaranty, i.e., it anticipates that payments it receives from a foreclosure sale will first be applied against the unguaranteed (or nonrecourse) portion of the loan and that the guaranty will remain in effect until the loan has been paid in full. The language in the guaranty regarding the guarantor's "top" obligation should therefore provide that foreclosure (or bankruptcy) sale proceeds will first be applied to the nonrecourse portion of the debt and that, to the extent the proceeds are insufficient to fully pay the loan, the guarantor remains personally liable for the difference. See, e.g., *University Savings Ass'n v. Miller*, 786 S.W.2d 461, 463 (Tex. App. 1990) (guaranty language, which guaranteed top 10% of all amounts owing on debt, explicitly

provided that lender was not required to apply foreclosure proceeds to unguaranteed portion of debt before applying it to indebtedness owed by guarantor)

CONCLUSION

The cases discussed in this article clearly highlight the risks and dangers to lenders in taking limited and conditional guaranties from third parties as additional security for mortgage loans. Unless carefully and comprehensively drafted, a percentage or "burn down" guaranty, which provides for guarantor liability for a stated percentage of the debt, presents an especially attractive target for a challenge based on its "ambiguous" meaning. To what amount does the percentage apply – to the net amount after collateral recovery or to all amounts due and owing at the time of the borrower's default, or from "time to time"? Do regular principal payments received by the lender reduce pro-rata the percentage amount owed by the guarantor(s)? At what time is the amount determined – upon the borrower's default, upon notice to the guarantor(s) of the acceleration of the debt, or upon collection of all proceeds available from the loan collateral, whether by foreclosure, bankruptcy or other collateral sale? What about interest on the guarantor's unpaid

share of the principal balance of the loan? What about the lender's attorneys' fees and other expenses of collection? What about the order, proportions and priority of the application of amounts received by the lender? What about the application of proceeds received from personal property and other ancillary forms of collateral? If there is more than one guarantor, is the total liability joint and several or are all guarantors equally liable? Should the guaranty contain a "springback" or "clawback" provision that provides for reinstatement of the guarantor's (or guarantors') obligations if changing facts subsequently eliminate the condition or occurrence upon which the guaranty was initially released? All of these questions, and more, should be addressed and answered to the satisfaction of both the lender and borrower, and covered in the provision(s) of the guaranty limiting or conditioning the liability of the guarantor(s).

** Nothing in this Article is to be considered as the rendering of legal advice for specific cases, or creating an attorney-client relationship, and readers are responsible for obtaining such advice from their own legal counsel. This article is intended for educational and informational purposes only, and no warranty or representation is made as to the accuracy or completeness of the information contained herein. The views and opinions expressed in this Article are solely those of the Author, and do not necessarily reflect the views, opinions, or policies of the Author's employer, First American Title Insurance Company.*



Trans-Pacific Capital Flows: Asia rises as major source of cross-border capital for U.S. real estate investment

By: Jeanette I. Rice, Americas Head of Investment Research, CBRE, Inc.

NEARLY ONE-QUARTER OF AMERICA'S CROSS-BORDER CAPITAL COMES FROM ASIA

The current state of the U.S. investment landscape is heavily influenced by real estate capital flows from across the Pacific Ocean.

Asia has become a major supplier of capital for American real estate, acquiring \$7.0 billion of commercial real estate assets in the U.S. in 2014. This total represents nearly one-quarter of all cross-border capital acquisitions in U.S. real estate last year.

While this figure includes only direct investment of existing properties, the total would be considerably higher if investment in other vehicles such as funds, mortgage debt, residential condominiums, REIT stocks and development projects were included.

This ViewPoint focuses on the direct investment of Asian-based investors. It reviews the principal trends in Asian capital flows into



Jeanette I. Rice

U.S. commercial real estate, the establishment of Asian capital as a key source of cross-border capital and the central characteristics of Asian investment in the United States.

In absolute terms, Asian capital flows into the U.S. is still smaller than flows from Europe and North America — the latter represented by predominantly Canadian capital.

However, the total amount invested and the total market shares have both risen over the past several

years.

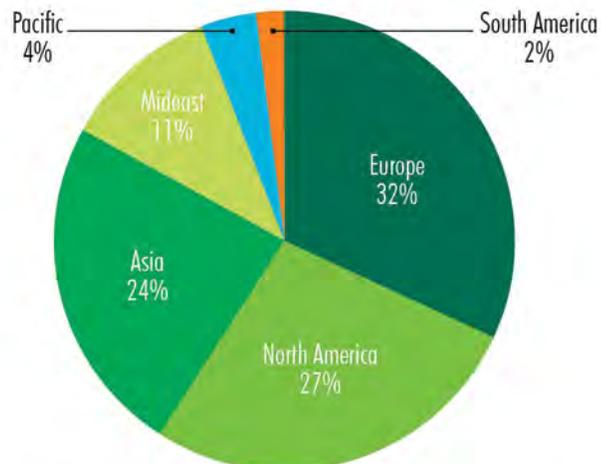
For example, in 2007 the Asian share of the cross-border investment market was approximately 6%, at \$1.5 billion. Since 2007, the region has gained market share almost every year. In 2014, the Asian buyers represented 24% of all cross-border investment in U.S. real estate.

The 2014 total of \$7.0 billion actually represented a small decline from 2013 — down 5.7% from \$7.4 billion. This was due, in part, to a handful of very large transactions closing in early 2015 rather than in 2014.

Despite this modest decline, CBRE Research projects that total direct Asian investment in U.S. real estate will rise steadily over the near term. This is based on a wide array of factors which include historical investment trends, current Asian investor sentiment and the recent sharp increase of Chinese interest and investment.

We also expect Asia's market share of cross-border investment to rise over the next few years.

Figure 1:
Direct Cross-Border Investment in U.S. Real Estate by Global Region, 2014



Source: Real Capital Analytics; CBRE Research, Q4 2014. Totals exclude pending sales, development sites and entity-level acquisitions.

Figure 2: Leading Asian Capital Sources for U.S. Commercial Real Estate Investment, 2014

Rank	Country Source of Capital	Total in Millions \$	2014 Change %	Market Share % of Total Asian Investment	2 Largest Property Type % of Total
1	China	1,962	3	28	Office (42%), Retail (25%)
2	Hong Kong	1,637	43	23	Office (89%), Hotel (9%)
3	Japan	1,138	99	16	Hotel (34%), Office (30%)
4	South Korea	912	-46	13	Office (99%), Industrial (1%)
5	Singapore	880	-54%	13%	Office (49%), Hotel (41%)
	All Others	445	131	7%	
TOTAL		6,988	-6%	100%	Office (57%), Hotel (24%)

Source: Real Capital Analytics; CBRE Research, Q4 2014. Totals exclude pending sales, development sites and entity-level acquisitions.

CHINA AND HONG KONG ARE LEAD SOURCES

Five investor nationalities dominated the market in 2014 and represented 93% of the total Asian investment in the U.S., as shown in Figure 2. China and Hong Kong led this group, accounting for more than half of the total. Japan and Hong Kong experienced the largest year-over-year increases. However, since Asian investments in the U.S. are typically large in terms of dollar volume, year-over-year differences are sometimes misleading.

The most remarkable story is China. China was hardly a player in the U.S. real estate investment arena until 2010, when acquisitions by Chinese investors first exceeded \$100 million. By 2013, Chinese investment had reached \$1.9 billion. Last year, China exceeded its 2013 total slightly, almost hitting the \$2.0 billion mark.

These statistics do not include development site acquisitions. Real Capital Analytics (RCA) data suggest that Asian investment in development sites reached over \$1.0 billion in 2014. The Chinese have become very active partners in development projects, additional capital that does not show up in the direct investment totals.

Los Angeles is a good example of this. In the Los Angeles marketplace, Chinese investors have not purchased many existing assets but instead have been primarily focused on multifamily. Two recent examples are the

Greenland Group's acquisition of the 6.3-acre Metropolis site in downtown Los Angeles and Dalian Wanda's acquisition of the 8-acre 9900 Wilshire site in Beverly Hills — both part of larger transformational mixed-use development projects. While cross-border capital tends to partner with domestic development firms, in these two cases, and others in Los Angeles, the Chinese firms are handling the development process on their own.

ASIAN INVESTORS SHOW STRONG PREFERENCE FOR OFFICE AND HOTEL PRODUCT

As a whole, cross-border capital favors office product for investment in the U.S., and Asian capital's preference is even higher. In 2014, Asian investors acquired \$4.0 billion of office product, or 57% of the total, as shown in Figure 3.

Currently, the second favorite property type is hotels at 24% of total investment in 2014. This market share is higher than in previous years, but the average for the past decade is still notable at approximately 19%.

The preference for office and hotel assets is largely due to three factors. First, large office and hotel assets are more "scalable," as investors can deploy more capital with each acquisition. Second, these U.S. assets are similar in design and operations to assets in other global markets that Asian investors are familiar with. Lastly, the office and, to a lesser extent, hotel sectors provide investors

an ability to acquire "trophy" assets, which are not only high dollar, but are often high prestige and/or internationally known.

Direct investment in the other property sectors was relatively small in 2014, as it has been in the years prior. However, that may change in the near future. Scale has inhibited industrial investment in the past—single assets are typically too small to attract attention. However, there has been considerable cross-border interest in the industrial and logistics sector. This interest may translate into more investment into the sector in the future as portfolios become available. Also, notable is the recent acquisition of IndCor. The \$8.1 billion entity-level acquisition, which is not included in our statistics, was by a joint venture between Singapore-based Global Logistic Properties and GIC (government of Singapore).

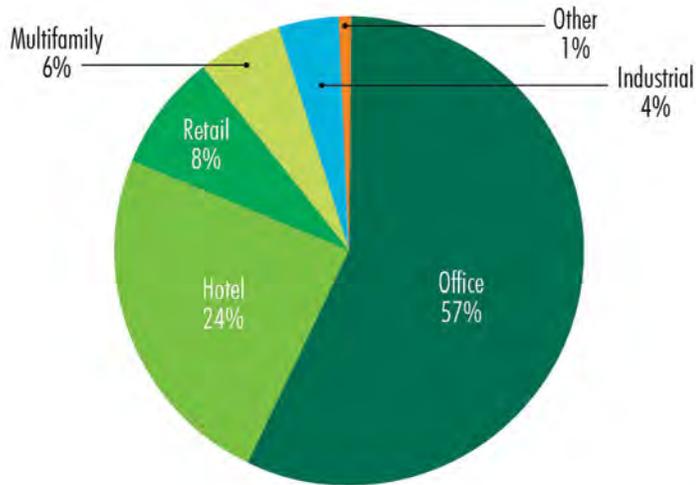
COASTAL METROS DOMINATE

In 2014, Asian investment was concentrated in four coastal metros; assets in Los Angeles, New York City, Washington D.C. and San Francisco made up for 75% of investment, as shown in Figure 4. Los Angeles alone captured 30% of the investment dollars.

While there is the sense that Asian investment is moving beyond the core markets, the 2014 statistics suggest that this movement is still very limited.

Asian investment in the other

**Figure 3:
Asian Investment
by Property Type, 2014**



Source: Real Capital Analytics; CBRE Research, Q4 2014. Totals exclude pending sales, development sites and entity-level acquisitions.

metro markets was limited to a very small number of transactions per market, sometimes just one. For example, fifth ranked Honolulu and Hawaii had two hotel investments by Japanese firms — one in Honolulu and one in Maui. Asian investment in Houston and Kansas City reflected just one asset in each metro. The Asian geographic bias is in-line with expectations, considering that the majority of Asian capital flows are still fairly new to the U.S. market, and are, therefore, likely to remain mainly focused on the core gateway metros in the short- to medium term.

ASIAN INVESTMENT RISING IN 2015

Asian investment is off to a strong start in 2015, with 20 closings totaling \$2.75 billion on the tally sheet year-to-date (as of late March). The largest transaction, by far, is that of New York's iconic Waldorf-Astoria Hotel for \$1.95 billion by Beijing-based Anbang Insurance Group. Also notable is Tokyo-based Jowa Holdings' acquisition of three \$100+ million Manhattan office buildings. In addition, Asian capital sources have acquired 14 development sites for a total of \$337.0 million year-to-date.

Not only is 2015 off to a strong start as evidenced by closed transac-

tions, CBRE Research's newly released Asia Pacific Investor Intentions Survey 2015 revealed that Asian outbound investment interest remains strong for 2015. Referring to future intentions, regardless of investment location, 56% of the Asia-based investors surveyed responded that they plan to invest more in 2015 than in 2014. Investors from Hong Kong and Singapore were the most enthusiastic in this regard. Chinese investors indicated that they are likely to be net sellers domestically, but net buyers abroad.

WHY INCREASED INVESTMENT FROM ASIA?

There are many factors for increased investment from Asia. Some of the "push" factors are the high pricing and low yield environments of the home markets. There is also the serious challenge of finding product at attractive pricing domestically.

Additionally, parts of Asia, including China, are currently finding themselves in somewhat challenging economic climates, which makes domestic investment less attractive.

Some of the "pull" factors include the more attractive yield and pricing environment of U.S. real estate. Certainly the strong U.S. economy and property fundamentals add to the interest and economic security of investment here. Long-term market

characteristics, such as the political stability of the U.S., the generally positive business environment, low and fairly predictable inflationary climate and other factors add to the appeal.

Additionally, the U.S. provides Asian investors with portfolio diversification benefits. Having said that, the strong U.S. dollar vis-à-vis most of the Asian currencies could be a short-term detriment to investing in the U.S.

The devaluation of Asian currencies relative to the U.S. dollars varies. The yen is at or near the top for most severe depreciation; it has fallen from a recent (mid-2012) high of about 78 yen to the dollar to 119 today.

On the other hand, the Chinese yuan-U.S. dollar exchange has not fluctuated very much in recent years. However, mitigating the impact of weaker Asian currencies is the investment strategy typical among Asian investors which favors long-term holds.

Perhaps most important for stimulating future Asian capital flows to the U.S., on the Asian side of the Pacific, are new sources of capital looking for investment opportunity. There have been legislative changes in Asia making it easier for Asian institutions to invest in the U.S., particularly insurance companies. Additionally, real estate allocations are rising in many Asian institutions which increase the need to find new investment opportunities.

Figure 4: Leading U.S. Metros for Asian Investment, 2014

Rank	Metropolitan Area	Total in Millions \$	Market Share %	2 Largest Asian Country Sources	2 Largest Property Types
1	Los Angeles	2,085	30	Hong Kong (55%), China (41%)	Office (55%), Retail (24%)
2	New York City	1,519	22	Singapore (48%), Malaysia (23%)	Hotel (43%), Office (40%)
3	Washington, D.C.	854	12	South Korea (81%), Hong Kong (8%)	Office (81%), Hotel (19%)
4	San Francisco	786	11	China (50%), Hong Kong (33%)	Office (79%), Multifamily (11%)
5	Honolulu (and Hawaii)	347	5	Japan (100%)	Hotel (100%)

Source: Real Capital Analytics; CBRE Research, Q4 2014. Totals exclude pending sales, development sites and entity-level acquisitions.

Mark Your Calendar

PREA Pension Real Estate Association — 25th Annual Investor Real Estate Conference
www.prea.org | September 30 - October 2 • San Francisco, California

CREW Commercial Real Estate Women — 2015 CREW Network Convention & Marketplace
www.crewnetwork.org | September 30 - October 3 • Bellevue, Washington

ULI Urban Land Institute (October) — ULI Fall Meeting
www.uli.org | October 6 - 8 • San Francisco, California

The Lodging Conference — The Lodging Conference 2015
www.lodgingconference.com | October 6 - 9 • Phoenix, Arizona

NAIOP Commercial Real Estate Development Association
www.naiop.org | October 13 - 15 • Toronto, Ontario

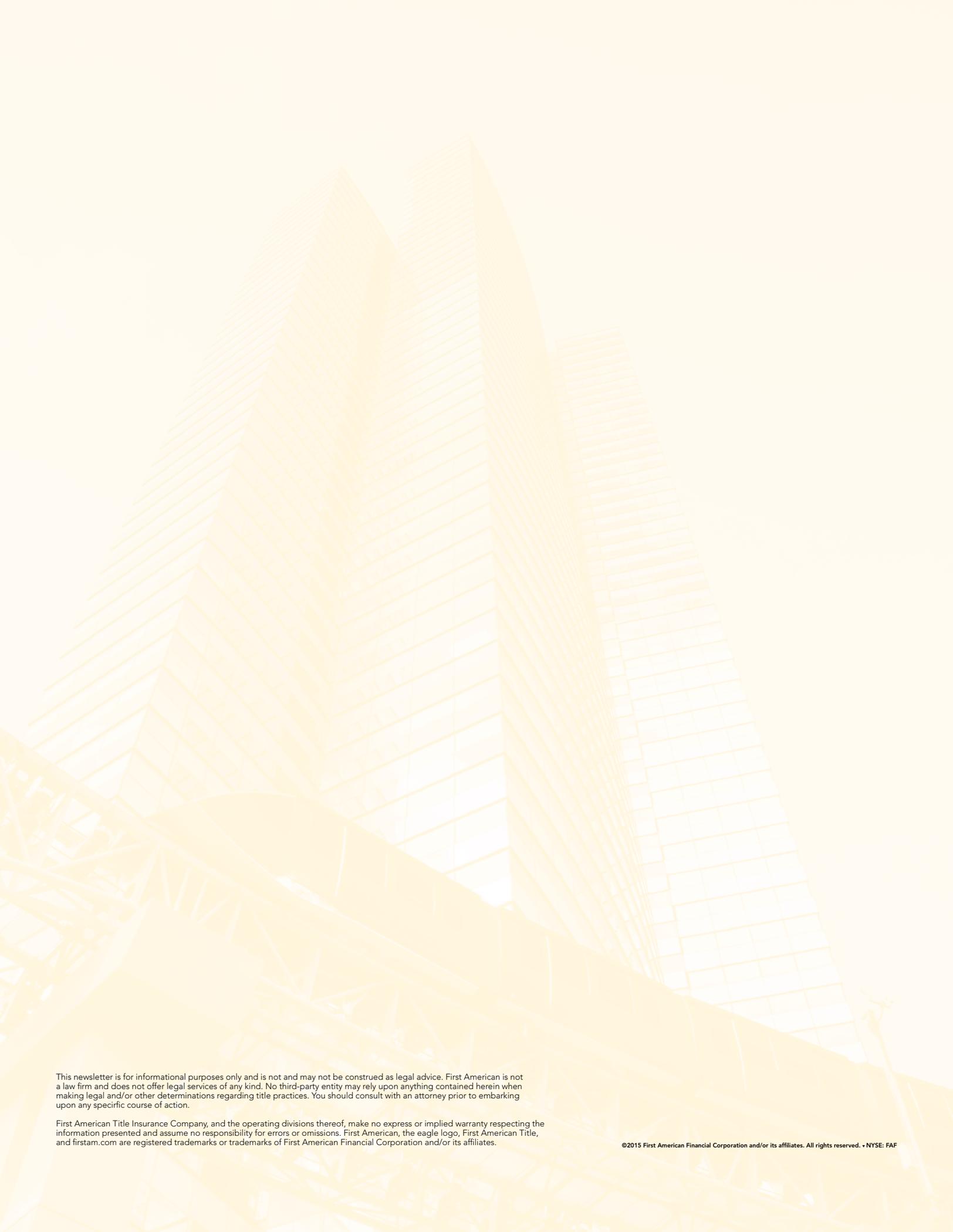
CoreNet Global Corporate Real Estate Network — CoreNet Global North American Summit
www.corenetglobal.org | October 18 - 20 • Los Angeles, California

MBA Mortgage Bankers Association — 102nd Annual Convention & Expo
www.mba.org | October 18 - 21 • San Diego, California

ICSC International Council of Shopping Centers — U.S. Shopping Center Law Conference
www.icsc.org | October 28 - 31 • Phoenix, Arizona

NAREIT National Association of Real Estate Investment Trusts — REITWorld: NAREIT's Annual Convention for All Things REIT
www.reit.com | November 17 - 19 • Las Vegas, Nevada

15



This newsletter is for informational purposes only and is not and may not be construed as legal advice. First American is not a law firm and does not offer legal services of any kind. No third-party entity may rely upon anything contained herein when making legal and/or other determinations regarding title practices. You should consult with an attorney prior to embarking upon any specific course of action.

First American Title Insurance Company, and the operating divisions thereof, make no express or implied warranty respecting the information presented and assume no responsibility for errors or omissions. First American, the eagle logo, First American Title, and firstam.com are registered trademarks or trademarks of First American Financial Corporation and/or its affiliates.

©2015 First American Financial Corporation and/or its affiliates. All rights reserved. • NYSE: FAF