contradicting a written contract, did not save the bank. One of the lessons to be learned from this is that loan officers must be careful about making any statements or promises that can be used against the bank in any future litigation.

Satisfying the Mortgage

In another recent case, a bank seemed to have made all of the proper decisions in granting a loan. It received appraisals, issued a form commitment, prepared and filed appropriate mortgage documents, filled in the blanks and obtained lenders' title insurance. Later, the borrower sought a release of a portion of the mortgaged property from the bank. The borrower brought the loan officer a standard document which would satisfy the mortgage (instead of releasing it), which the officer inadvertently signed. The borrower then satisfied the mortgage without paying the debt.

In addition to incorrect satisfactions, there are many other ways that lenders get into trouble after closing the loan. For example, there seems to be a current trend for borrowers to sue institutional lenders for failing to make advances under certain circumstances. Various buzz words are being used by borrowers to describe what is perceived by them as improper conduct. These range from "inequitable conduct," "lack of good faith," "breach of fiduciary duty" to "fraud" and "economic duress." These are difficult issues. However, as previously discussed, there are many more obvious mistakes which simply stem from a failure to understand the documents that are delivered for signature.

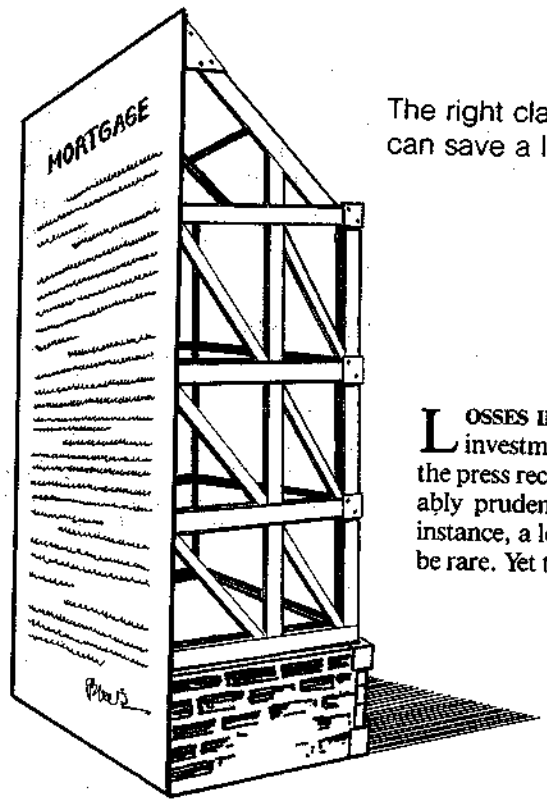
CONCLUSION • This article has discussed just a few of a potentially limitless number of loan pitfalls. It has not covered many of the more complex issues involving construction lending, equity kickers, secondary financing, or loan administration. Knowing even a few of the pitfalls, however, may alert a lender to others; and with proper caution he may make it across the rutted fields without a dangerous fall.

How To Protect Mortgage Value with Astute Mortgage Drafting

(with Forms)

Bruce J. Bergman

The right clause in the right place can save a lender a lot of money.



LOSSES INCURRED ON MORTGAGE investments have been noted in the press recently. Assuming a reasonably prudent investment in the first instance, a loss on a mortgage should be rare. Yet they do occur, and this ar-

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ticle outlines some methods for avoiding these losses.

SUCCESSFUL FORECLOSURE • When a loan goes into default and a foreclosure action is the ultimate result, the success or failure of the action may be based upon three general aspects in varying combinations.

Equity Cushion

First, obviously, a monetarily safe loan is a factor. When the equity is substantial, that "cushion" aids in precluding a loss.

The development of a safe loan, however, is not always easy for several reasons:

- An unexpected downturn in values at a particular location can have a deleterious effect;
- Property may become physically run down if portfolio management is less than meticulous; and
- A favored borrower may not be scrutinized in depth at originization time.

Thus the making of prudent loans cannot always be relied upon.

Yet these problems should not be such an impediment. Although economic downturns do exist, sudden changes in neighborhoods are not particularly pervasive. When appraisals are faulty, better appraisers can be hired. Finally, the valued borrower who receives special treatment is not that common. So these conditions should not be the main causes of mortgage losses.

Attorney Competence

Another category to consider is the skill of the attorneys engaged to prosecute the actions. Mortgage foreclosure is an arcane, highly technical, and ritualistic calling, which truly requires an expertise and experience to be pursued expeditously. If the foreclosing lender is employing attorneys who do not possess the appropriate background, their deficiencies will be noticed eventually, and new counsel can be obtained. But even when the practitioner is an expert, he is bound to foreclose upon the documents given to him.

Faulty Documents

Documentation is an area that offers room for much improvement and appears to be the area too often neglected—for reasons that are not difficult to understand. As noted, the lack of ability of some appraisers or attorneys is a factor that will become apparent rather naturally, therefore presenting an easy remedy.

If the difficulties are because of the quality of the mortgage documents themselves, however, this may be quite slow to surface—if, indeed, it ever becomes noticeable. The attorneys in charge of the foreclosure may not be aware of the nuances in the papers that, if perceived, could make the foreclosure more efficient. This is the case especially if the attorneys prosecuting the action did not also prepare the mortgage documents. Even if the prosecuting attorneys do have the requisite knowledge, the press of a heavy litigation schedule can preclude their making this known to the lender.

Conversely, the mortgage drafters may not be the attorneys in charge of the foreclosure. They would thus be insulated from the practical effect of their intended language in the foreclosure case. Therefore, deficiencies in the mortgage instruments can unknowingly remain obscure. Accordingly, how the lender can avoid those possible shortcomings is well worth exploring.

LEGAL FEES • It would not be practical to analyze every conceivable clause in every mortgage. Yet there are areas particularly fertile for improvement, and one of these areas is legal fees.

Mortgage foreclosures tend to be recondite, time-consuming, and usually expensive. Especially when a foreclosure becomes protracted—as when vigorous defenses or a bankruptcy are encountered—legal fees incurred by the lender can be substantial. If these fees are not included in the foreclosure judgment—because the mortgage documents did not so provide—when the value of the property is close to the loan amount, the legal fees might easily be the difference between a loss and being made whole.

Standard Forms

Interestingly, many standard forms of mortgage do not contain a clause allowing for legal fees in a foreclosure. Rather, these forms may provide reimbursement for legal fees expended only in protecting the lien of the mortgage. That is a situation quite different from a foreclosure action. Thus in formulating the mortgage documents and adapting the applicable forms, the drafter must be aware of this difference. In some states, a legal fee clause in the foreclosure section of the note alone is insufficient—it must be in the mortgage document itself.

"Reasonable" Legal Fee Approach

Mindful that the legal fee clause is essential, there are two ways to prepare it. One method is to provide for "reasonable" legal fees. The attorney for the foreclosing lender is well-advised to keep thorough time records in the foreclosure action so that when the court considers the award, these records will support the claim. What the lender pays its attorney is not the measure; rather, the measure is the amount of time reasonably engendered by the circumstances of the case at the attorney's usual hourly rate. Whether the court accepts the attorney's regular billing rate depends upon counsel's experience, standing in the legal community, and years in practice.

It is significant that house counsel is not entitled to a separate legal fee

award, as they are considered employees of the lender. Thus, consideration should be given by the lender to the engagement of outside legal counsel to recoup this rather substantial outlay.

Two examples of typical clauses providing for legal fees are as follows:

"Reasonable" Legal Fees Clauses

Mortgagor agrees that on the foreclosure of this mortgage there shall be included in the computation of the amount due the amount of a fee for attorney's services in the foreclosure proceedings as well as all disbursements, allowances, additional allowances, and costs provided by law.

or

If this mortgage is foreclosed, an amount of _____ Dollars ($_____) shall be added to the principal debt as attorney's fees. This shall be in addition to the right of the mortgagee to assess, tax, and recover all disbursements, allowances, additional allowance, and costs provided by law.

If the "reasonable" legal fee approach is to be used, one of these clauses, or any appropriate variation, must be included in the mortgage document. Absent clear language in the mortgage document granting legal fees in the foreclosure, in most jurisdictions these fees just will not be recoverable by the lender.

"Percentage" Fees Clause

An alternative approach to protect the lender is to set forth recoverable legal fees in the mortgage document as some percentage of the outstanding loan balance. The fees are added to the outstanding indebtedness secured by the mortgage. An example of a proven clause is the following:

"Percentage" Fees Clause

If the holder of this Mortgage is required to retain legal counsel for the purpose of commencing foreclosure proceedings under this Mortgage, a sum equal to __ per cent (__%) of the unpaid balance collaterally secured by this Mortgage shall be added to the indebtedness as fair and reasonable legal fees and deemed secured by this Mortgage in addition to costs, allowances, and additional allowances as provided by law.

Should there be a "plain English" or "plain language" requirement in your state, a similar percentage clause that should comply is as follows:

"Plain Language" Percentage Fees Clause

You may ask an attorney either to foreclose this Mortgage, to collect money I owe under the Note and this Mortgage, or to enforce any of the promises I have made. If you do so, you may add all reasonable legal fees, which I agree shall be __ per cent (__%) of the unpaid debt. If the Lender obtains a judgment of foreclosure, I will pay interest on the amount of the judgment at the rate specified in this Note.

Often, this plain language approach yields a more favorable result and at the very least gives the court more latitude to grant reasonable fees based upon actual hours expended—which can often be less than the percentage of the loan balance. The only possible shortcoming of this method is that courts in some states may view the percentage as a "cap" or maximum percentage. Yet foreclosures that are so heavily litigated so as to engender legal fees in excess of the percentage should be rare enough; thus this approach should prove advantageous in the majority of situations a lender will face.

Bankruptcy Petitions as a Defense Tactic

As many attorneys know, an increasingly common defensive tactic is the defaulting mortgagor's filing of a petition in bankruptcy. This creates still further legal costs. Therefore, it is a good idea to consider a clause in the mortgage document providing for legal fee reimbursement, specifically for possible bankruptcy litigation, in addition to the legal expenses in the foreclosure action itself.

Attorneys' fees clauses pressure the defaulter to make good, because the more he delays and litigates, the more it will cost him

Lest all this be misconstrued as merely a device to enrich attorneys, clients should bear in mind that the more legal fees that go into the foreclosure judgment—or are paid directly by the mortgagor—the less the lender will have to pay. In addition, an attorneys' fee clause puts considerable pressure on the defaulter to make good his obligation because the more he delays and litigates, the more it will cost him. Thus careful drafting here serves the dual purpose of reimbursing the lender and bringing the litigation to a more rapid conclusion.

INTEREST ON DEFAULT • Because foreclosures tend to be lengthy under the best of circumstances, particularly when defended assiduously, the rate of interest generated upon de-

fault is absolutely critical to the lender. In New York, for example, what is called the "legal" or "judgment" rate is nine per cent, somewhat below market levels. If a mortgage is silent as to the interest upon default, the applicable percentage will be that nine per cent, or whatever the comparable percentage may be in the applicable jurisdiction.

Protracted Litigation

If the litigation is protracted, and if the mortgage is high, the lost interest can be a significant amount. Thus the remedy is for the mortgage document to specify that, upon default, the balance will bear interest at the rate of the mortgage. The mortgage could even specify a higher rate, such as the highest rate of interest allowed by law. The result would be that, even on default, the principal of the loan would yield a respectable return, thus diminishing any damage caused by a foreclosure mired in convoluted litigation.

Using the plain language formulation, an example of a clause authorizing the contract rate of interest to apply from the moment of default is the following:

Interest on Default Clause

If Lender requires Immediate Payment In Full, I agree to pay interest on the entire amount remaining unpaid at the rate stated in the Note, from the date I failed to keep any promise or agreement made in the Note or in the Mortgage.

Interest on Advances

Interest on advances is a valuable corollary to the concept of interest when a default results.

Suppose a mortgagor allows insurance to lapse. The lender then must pay the premium to protect the security. Again, if the mortgage does not refer to such an eventuality, the money advanced to pay the insurance will yield only that low "legal" rate. But the mortgage document could—and should—recite that insurance advances incur interest at the mortgage rate, or some higher percentage. In a large mortgage portfolio, this concept becomes quite significant.

Of course, insurance is not the only advance a lender is likely to make. When real property taxes are not paid, or when the escrow for real property taxes is overdrawn, the lender must pay those taxes, or the lien of the mortgagee will be extinguished by a tax deed to the taxing authority, or possibly an *in rem* action. Hence, sums paid by the lender for taxes should also bear interest at the mortgage rate.

The Second Mortgage

When the lender is holding a second mortgage position, it may be required to protect its lien by making payments upon or even satisfying a prior mortgage. These advances also should have an interest rate greater than the judgment percentage.

To accomplish this goal for the lender, a suggested advance clause for inclusion in the mortgage document is the following:

Second Mortgage Interest Advance Clause

Interest on Amounts Spent by Lender To Protect the Property or Lender's Rights in the Property

I agree to pay interest at the same rate stated in the Note, on all amounts that I must repay to Lender, which Lender may spend to protect the Property or Lender's rights in the Property, all as described in paragraph _____ of the Mortgage.

DURATION OF INTEREST ON DEFAULT • In most jurisdictions, the last step before advertising the sale of property securing a defaulted loan is the entering of the judgment. But once the judgment is obtained, the total amount owed the lender will only bear interest at the judgment or the legal rate—unless the mortgage document provides to the contrary.

Dilatory Tactics

Unfortunately for many lenders, the mere obtaining of a judgment does not assure that the litigation is completed. There is always room for dilatory tactics—legitimate or otherwise—by the defaulting mortgagor, such as:

- Choosing the eve of sale to file for bankruptcy, which is then the cause of extensive delay;
- Suddenly claiming that he was never served with process in the foreclosure and requesting an opportunity from the court to submit an answer; or
- Coming forward with a host of other claimed reasons for an order to show cause to stay the sale.

If the mortgagor is successful with any of these efforts, the lender's judgment could yield that relatively low "legal" rate of interest for an extended period. This in turn could severely jeopardize a loan when the margin between the sum due on the mortgage and the value of the property is "close." The solution is to provide in the mortgage document that the contract rate of interest will apply until the property is sold or until the full amount due is paid, whichever comes later.

A simple continuing interest clause to be adopted by the lender for use in the note and the mortgage, if desired, is the following:

Continuing Interest

I will pay interest at a rate of ___ per cent (___%) per year. Interest will be charged on that part of the principal that has not been paid. The interest will be charged beginning on the date of this Note and continuing until the full amount of principal has been paid.

ADDITIONAL CHARGES • Suppose the mortgagor submits a check with insufficient funds in his account to cover it, which does occur with some frequency. The fee incurred by the lender for a bounced check is inconsequential. Yet some mortgagors do that with regularity. When this fee is multiplied through a large portfolio, those insignificant expenses become matters of substance. When this happens, not only has the lender expended a direct charge, but interest has been lost on the payment that should have been submitted by the mortgagor. The latter result occurs also when a payment simply is submitted late.

In addition, if the lender is not escrowing for taxes, determining the status of tax payments could require searches. Considering again a large portfolio, the costs of these searches can become expensive to the lender. Among many other examples of peripheral charges that can mount significantly are those incurred in the processing of:

- Insurance loan payments;
- Ownership transfers;
- Easements;
- Extensions or modifications;
- Reduction certificates; and
- Satisfactions and assignments.

If the mortgage does not provide reasonable reimbursement to the lender for these charges and expenses, recompense will not likely be available.

Late Charges

There are, then, three areas for the lender's counsel to cover. First, there is a need to provide a clause in the mortgage document for late charges. A typical example follows:

Late Charge for Overdue Payments

If Lender has not received the full amount of any monthly payment by the end of 15 calendar days after the date it is due, I will pay a late charge to Lender. The amount of the charge will be two per cent (2%) of my total overdue payment of principal and interest.

Second, the document should contain a reimbursement clause for charges incurred by the lender, such as the following:

Additional Charges

I agree to pay all reasonable charges in connection with the servicing of this loan including, but not limited to, obtaining tax searches and bills and in processing insurance loss payments, ownership transfers, releases, easements, consents, extensions, modifications, special agreements, assignments, reduction certificates, and satisfactions of mortgage.

The clause to assure interest to the lender at the contract rate for advances should be more extensive. One way it has been done is in this fashion:

Lender's Right To Take Action To Protect the Property

If I do not keep my promise and agreement made in this Mortgage, or someone, including me, begins a legal proceeding that may significantly affect Lender's rights in the Property (such as, for example, a legal proceeding in bankruptcy, in probate, for condemnation, or to enforce laws or regulations), then Lender may do and pay for whatever is necessary to protect the value of the Property and Lender's rights in the Property. Lender's actions under this paragraph may include, for example, appearing in court, paying reasonable attorneys' fees, and entering on the Property to make repairs. Lender must give me notice before Lender may take any of these actions.

I will pay to Lender any amounts, with interest, that Lender spends under this paragraph _____. This Mortgage will protect Lender in case I do not keep this promise to pay those amounts with interest.

I will pay those amounts to Lender when Lender sends me a notice requesting that I do so. I will also pay interest on those amounts at the same rate stated in the Note. If payment of interest at that rate would violate the law, however, I will pay interest in the amounts spent by Lender under this paragraph _____ at the highest rate that the law allows. Interest on each amount will begin on the date that the amount is spent by Lender. Lender and I may, however, agree in writing to terms of payment that are different from those in this paragraph _____.

Although Lender may take action under this paragraph _____, Lender does not have to do so.

Interest on Amounts Spent by Lender To Protect the Property or Lender's Rights in the Property

I agree to pay interest at the same rate stated in the Note, on all amounts that I must repay Lender that Lender may spend to protect the Property or Lender's rights in the Property, all as described in paragraph _____ of the Mortgage.

DUE-ON-SALE-CLAUSE • Today's mortgage at 10 per cent could be a very poor investment some years in the future. Obviously, a lender is as bound by his contract as is the mortgagor. But absent the requirements in government subsidized mortgages, such as FHA, a mortgage need not be assumable.

This was a lesson learned in the late 1960's and early 1970's when quiescent mortgage rates suddenly became volatile. Therefore, most mortgages today should, and prudently do, contain what is called a "due-on-sale" or "due-on-transfer" clause. This gives the lender an opportunity to keep a portfolio competitive.

Mortgage documents that do not contain such a provision may present an economic risk. Assuming the terms are found in your mortgage document, nevertheless, it is vital that the language be all-encompassing to reach the desired result.

For example, if the mortgagor is a corporation, a stock sale could effectively nullify the "due-on-sale" clause—unless that clause is specific enough to cover that contingency.

If, in a gesture of fairness, the lender's mortgage provides that its consent to a sale will not be unreasonably withheld, the "due-on-sale" clause has probably just been rendered entirely ineffectual.

Comprehensive Clause

Thus, careful drafting is particularly important here as well. An example of a comprehensive clause to consider is the following:

Due-on-Sale Clause

This Mortgage shall become due and payable, at the option of the Mortgagee, if the Mortgagor shall convey away the mortgaged premises or if the title to the mortgaged premises shall become vested in any other person, corporation, or entity in any manner whatsoever, including, but not limited to, operation of law. If the Mortgagor is a corporation, a sale of more than fifty per cent (50%) of stock shall be deemed a transfer for the purpose of this clause.

RECEIVERSHIP • Unlike the other clauses mentioned in this article that are frequently overlooked, a paragraph empowering a lender to appoint a receiver in foreclosure has long been considered a standard one. Lenders should be certain that such a clause is definitely made part of their mortgage documents. Of course, there is a difference between having the clause in the documents and actually implementing it under appropriate circumstances.

For example, suppose a defaulting mortgagor concludes that his economic interests are best served by delaying interminably the foreclosure. Although the running of interest at a higher rate, together with the imposition of legal fees, provides a modicum of protection for the lender, the consequences of extensive delay can still be damaging. This can occur when the mortgaged property is an apartment building, group of stores, or other income-producing property.

It may be to the mortgagor's advantage to collect rents and neglect repairs, thus allowing the property to decline severely in value. That obviously jeopardizes the lien of the mortgage since, at the conclusion of the extended litigation, the property may be worth less than the lender's total investment.

Receivership Advantages

The best way to solve this common problem is to obtain the appointment of a receiver as authorized by the mortgage documents. It is a remedy that should at least always be considered. If the lender believes the property may be reduced in value during the action, or that the mortgagor may allow the premises to run down, a receivership is definitely in order. When litigation is expected to be protracted, it can also be considered for a one-family house foreclosure.

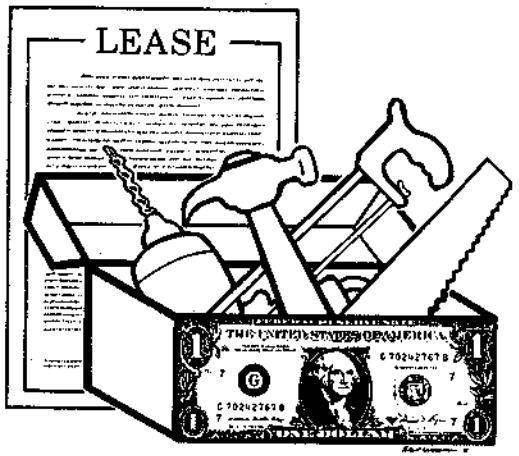
A receiver stands in the shoes of the owner. Once he is appointed and qualifies, he has the right to collect all rent due or that is to become due arising out of the premises. He collects the income, maintains the insurance, pays taxes, and makes repairs. He thus preserves the value of the property.

In addition, any income left over is used to reduce the mortgage. Thus a dual purpose is served. Also, the mortgagor's interest in delaying the foreclosure is greatly diminished, if not entirely eliminated. Many favorable settlements have been obtained as a result of receiverships.

Significantly, receiverships are most often obtainable without notice to the mortgagor. When he finds out, the mere existence of the receivership is frequently enough to solve the problem. To be sure, a mortgagor could choose to litigate the issue of the receivership rather than capitulate. But it is quite difficult to set aside a skillfully obtained receivership. Technical objections rarely succeed, and constitutional challenges have been rejected.

CONCLUSION • Although there are many mortgage clauses that can be improved, no one article could ever explore every nuance of every conceivable situation. But experience with foreclosures reveals that the points discussed in this article can, as both a practical and a technical matter, be most helpful in protecting the mortgage investment.

The next time a problem arises in a foreclosure, consider whether other language in the mortgage documents could have provided a solution. If the answer is yes, you have found a clause to revise. In the meanwhile, even if your form of mortgage is time-tested, there is always room for improvement, and the quest to improve the documents should always be a priority.



Emerging Trends in the Financing of Shopping Center Tenant Improvements (with Forms)

Morton P. Fisher, Jr.

Many of the new methods for financing tenant improvements to shopping center space call for special form provisions, which are set forth here.

DURING THE GOLDEN YEARS of regional shopping center development, the financing of improvements by a space tenant was seldom a complicated matter. The landlord would commonly complete the shell of the building, the mechanical, electrical, and other systems, and the

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