DIRT Periodic Development for Monday, April 29, 2013
R.E. Loans, LLC v. Investors Warranty of Am., Inc.

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We had an interesting decision recently in California where a commercial lender who had agreed to subordinate to a $4 million loan claimed that didn't have to give up his priority because the new loan – although it was only for $4 million - also included cross collateral and cross default provisions that tied it to two other loans, totaling over $20 million. The appellate court's answer was that the subordination still worked because those other two loans would be simply junior to the subordinated lender's original loan. CEB's description and my Editor's Take on the decision are below.

After borrower's default, lender could have protected its interest in subordinated note secured by trust deed covering two additional notes by tendering only its interest in its own note.

R.E. Loans, LLC v. Investors Warranty of Am., Inc. (2013) 212 CA4th 1432

First Lender entered into a subordination agreement with Second Lender covering its note of $4 million. The new trust deed secured three notes on the same property totaling $21 million. The loans were cross-defaulted and cross-collateralized. When Borrower defaulted, the trustee issued a notice of default stating a cure amount of $26 million. Investors bought the property at a trustee's sale for $4.625 million. First Lender brought an action seeking a declaratory judgment that its deed was a first lien on the property and thus unaffected by the trustee's sale. The trial court granted summary judgment to First Lender and the court of appeal reversed.

Under the subordination agreement, First Lender's $4 million note was junior under the new trust deed securing all three notes. But to the extent that the new $21 million trust deed secured other notes, it was junior to the original trust deed—just as if the notes had each been secured by an independent trust deed. Thus, on default, First Lender could have cured the default and preserved its interest in the property simply by tendering the $4 million under its note only. Because it did not do so, the trustee's sale extinguished First Lender's interest in the property. The cross-default and cross-collateralization clauses were not binding on First Lender.

The Editor's Take: The subordinated junior lender holding a $6.5 million deed of trust on the same land that secured a senior loan of $4 million should have prepared itself to bid over that $4 million amount, once it received notices of default and sale by the senior, if it believed that the property was worth more than the senior loan amount. Instead, it took the risk that it could ignore that sale now and later invalidate the subordination agreement, thereby accomplishing a complete reversal of priority of the two loans and capturing the entire value of the property. That was an unwise gamble,