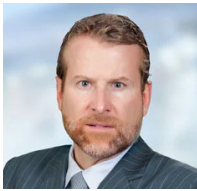


Commercial Real Estate Loan Defaults and Remedies (PA)

A Practical Guidance® Practice Note by Andrew K. Stutzman,
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This practice note discusses borrower default and lender remedy provisions in commercial real estate financing documentation used in Pennsylvania and provides an overview of commonly used workout options. Where appropriate, this note includes negotiation tips for counsel to the borrower and the lender.

For further guidance, see [Commercial Real Estate Financing Transactions \(PA\)](#), [Foreclosure of Real Property](#), and [Workouts of Commercial Real Estate Loans](#).

For related templates, see [Mortgage, Assignment of Leases and Rents, Security Agreement, and Fixture Filing \(PA\)](#) and [Promissory Note \(Acquisition Loan\) \(Pro-Lender\) \(PA\)](#).

Background and Preliminary Considerations

As in any commercial transaction, the front-end negotiation of terms in a commercial real estate loan transaction is critical. Clarity should be the objective. This will ensure that the loan documents clearly state all material considerations, the parties are in a meeting of the minds, and the transaction can proceed in a smooth and efficient manner to realize the parties' respective business objectives. However, best-laid plans in business often do go awry. In these instances, where a lender has lent money, there must be a process that protects the parties' diverging interests while mitigating the damage of default. To that end, there are certain remedies

available to the lender and corresponding protections available to the borrower. Some of these remedies are dependent on the inclusion of express terms in the underlying loan documents. Others derive from caselaw or statutory authorities. Regardless, the parties should consider, during the initial negotiation process, what should happen if material changes in circumstances occur. This will give the parties the opportunity to structure their agreement in a way that protects their respective interests and streamlines resolution processes. If the parties fail to consider these issues at the start, the way forward may be uncertain, with the only certainty being increased risk and cost.

Loan Terms and Covenants

An initial area of negotiation should involve loan covenants, which are terms that require the borrower to fulfill certain conditions or avoid certain actions. They may be financial covenants tied to the borrower's operations, such as maintaining a certain debt-to-equity ratio, level of cash flow, or earnings before interest, taxes, and depreciation. The commercial real estate lender needs to ensure that the business attendant to the real estate will service the debt through full and timely payments and fulfill other obligations. These covenants, which are essentially canaries in the coal mine, are material and can trigger events of default if the borrower fails to comply with them. They are therefore integral to the ongoing relationship between the lender and the borrower. Note that numerous factors, including loan-to-value ratio, the current state of the market and availability of credit, and the track record of the property, may affect the terms and covenants that a lender requires in a given transaction.

Lender Type

Loan terms and covenant requirements may also vary based on the type of lender involved. So-called hard money lenders—usually private investors or a pool of passive investors creating a managed fund—may take a different approach than conventional lenders. Hard money lenders may invest in individual loans or in a fund that manages a portfolio of loans. Their loans are customarily shorter term, such as six months or one year, and the loan terms, including the principal, rate of interest, and down payment (sometimes 20% to 30%), may be more directly tied to the collateral. This differs from conventional lenders—such as banks or credit units—which usually tie such loan terms to the borrower’s ability to repay from ongoing income. If the loan defaults, hard money lenders often expect to be repaid by taking the collateral and selling it. In doing so, they foreclose on the entire real property serving as collateral and forfeit interest payments that the borrower may have made in the future.

Non-recourse and Recourse Loans

Lenders tend to structure commercial real estate loans as non-recourse loans. A non-recourse loan is secured by real estate and possibly other collateral. When a loan is structured as non-recourse debt, the borrower is not personally liable for the debt or the lender’s losses except in the case of specific bad acts (e.g., fraud or misappropriation of rents or assets). These bad acts are called non-recourse carve-outs.

Of course, the borrower in a commercial real estate transaction may be a single purpose entity (SPE), set up to own and operate a single real estate asset. In such circumstances, recourse from the borrower may be inherently limited in any event. The lender may therefore require the sponsor to provide a guaranty, known as a non-recourse carve-out guaranty or a bad boy guaranty, to cover the lender’s losses resulting from the borrower’s bad acts.

The loan documents for a non-recourse loan may limit the lender’s enforcement of the loan to an action in foreclosure. Further, they may require the lender to look solely to the real property and other collateral securing the loan and limit the lender’s potential recovery to the amount of the debt. Bad boy carve-outs to this non-recourse feature may extend the borrower’s and guarantor’s liability to the lender’s actual losses resulting from an impairment of the collateral’s (such as waste of the collateral or failure to pay property taxes) or for events that impair the lender’s ability to realize upon the collateral (such as a borrower’s bankruptcy that stays foreclosure proceedings).

Commercial lenders typically just want to be repaid and do not want to take ownership of the real property. Acquiring other real estate owned (OREO) property (i.e., property that

the bank acquires in satisfaction of debts and does not use to conduct its business) generates carrying costs and raises specific accounting and banking regulatory issues. See, for example, the [regulations](#) that the Office of the Comptroller of the Currency has issued covering OREO activities for national banks and federal savings associations. These and other regulations, which seek to mitigate the impact of real estate losses and ensure the safety and soundness of the banking institution, can trigger additional reserves against capital, which in turn may limit further lending capacity. For these reasons, commercial lenders usually do not want to own and operate real property and may instead be inclined to pursue a loan workout with the borrower.

When a commercial loan is structured as recourse debt, on the other hand, the borrower is personally liable for the debt. If money remains due after the mortgaged property is sold through a judicial foreclosure, the lender may pursue a deficiency judgment against the borrower for the balance. This allows the lender to collect what is owed for the debt even after the lender has foreclosed on the mortgaged property.

For more information on recourse carve-out guaranties, see [Developments in Recourse Carve-Out Guaranties and Guaranty and Indemnification Agreements in Acquisition Loan Transactions](#).

Sureties and Guarantors

Sometimes, a surety or guarantor can guarantee performance or payment of the loan. This gives the lender additional recourse, upon the borrower’s default, against the surety or guarantor and its available assets.

The parties should be aware that Section 1691(a)(1) of the Equal Credit Opportunity Act (ECOA) (15 U.S.C. § 1691(a)(1)) protects individual spouses who guarantee a debt merely due to their marital status. A lender may not discriminate against an applicant based on his or her marital status or require a spousal guaranty or co-signor if the applicant qualifies under the lender’s standards of creditworthiness for the amount and terms of the credit requested (except in specific circumstances). See Section 202.7(d)(1) of Regulation B, 12 C.F.R. § 202.7(d)(1). A lender may not require a spouse to sign a credit instrument unless (1) the spouse and the applicant are joint applicants or (2) the lender has determined that the applicant is not creditworthy. It is unclear, however, whether the spousal discrimination defense of the ECOA applies when a spouse has been asked to sign a guaranty securing the debt of a business entity rather than that of the other spouse (e.g., if spouses are guaranteeing the debt of a business entity). See *Commonwealth v. Buhler*, 2019 Pa. Commw. Unpub. LEXIS 382 (July 10, 2019). Regardless, to avoid liability under the statute, the lender should act in

strict compliance with the ECOA and properly document the circumstances of the transaction. For more information on the ECOA and other fair lending laws, see [Fair Lending Laws and Enforcement Trends](#).

Mortgage Law Theory and Foreclosure Proceedings

The title theory of mortgages deems a mortgage to be a conveyance, while the lien theory holds that a mortgage merely represents a security interest. Pennsylvania does recognize elements of both the title theory and lien theory of mortgages. See *Pines v. Farrell*, 848 A.2d 94, 99 (2004). In general, however, Pennsylvania is considered to follow the lien theory of mortgages. In *re Phila., Fortieth Ward*, 63 A.2d 42 (1949); Pennsylvania Transaction Guide--Legal Forms § 186.20.

A mortgage evidences security for the loan and is recorded in the local land records, often called the recorder of deeds. The lien of the mortgage is perfected when the mortgage is recorded. See 21 Pa. Stat. Ann. § 621. A commercial mortgage differs from a residential mortgage, which is used for consumer transactions and is subject to many consumer protection statutes. While a consumer mortgage requires various notices and relief provisions before foreclosure, a commercial mortgage does not. Instead, the commercial mortgage generally follows its own terms for notice of default, and the applicable rules of civil procedure govern its remedy of foreclosure. In Pennsylvania, that means a relatively straightforward process of mortgage foreclosure under the Pennsylvania Rules of Civil Procedure. A similar process applies to actions initiated in or removed to Pennsylvania federal courts.

While some states are considered nonjudicial foreclosure states that offer deeds of trust to provide a relatively streamlined foreclosure process outside the courts, Pennsylvania is a judicial foreclosure state that requires a formal complaint in court to commence foreclosure. The process leads to a judgment and a writ of execution to the sheriff to conduct a sale of the real estate. The case can also include discovery, and limited counterclaims and defenses may be available as well. For more information on foreclosure proceedings in Pennsylvania, see [Foreclosure Resource Kit \(PA\)](#).

Documentation

The loan documents in a commercial real estate mortgage transaction often include:

- A loan agreement, which sets forth various terms and conditions, covenants, events of default, and rights and remedies
- A promissory note, which evidences the indebtedness and contains a promise to repay

- A mortgage, which is the security instrument that creates a lien on the real property and its fixtures
- An assignment of leases and rents, which grants the lender an assignment of the borrower's interest in leases and the rents at the property
- A guaranty, which protects the lender should the borrower fail to meet its loan obligations
- UCC-1 financing statements, which perfect the lender's security interest in certain borrower assets
- Authorizing resolutions from the borrower (and any parent and guarantor organizations, if applicable), which authorize entry into the transaction and execution of the loan documents
- A cash management and account control agreement, which grants the lender control over the borrower's accounts
- A post-closing compliance agreement, which governs matters arising after the closing date

In addition to the lender and borrower, parties to the loan documents may include subsidiaries, affiliates, partners, members, and stockholders of the borrower or guarantor, all of which may be subject to the lender's remedies.

Enforcing the Obligation

A party foreclosing on a mortgage must own or hold the note secured by the mortgage; the mortgage is "only the security instrument that ensures repayment of the indebtedness under a note to real property." *CitiMortgage, Inc. v. Barbeatz*, 131 A.3d 65, 68 (Pa. Super. 2016). The mortgage has no separate existence from the note and, when a note is paid, the mortgage is extinguished. *Id.* The holder of the note may, however, elect to proceed in action only on the note and forgo foreclosure on the mortgage. *Id.*

Given that a note securing a mortgage is a negotiable instrument (see 13 Pa. Cons. Stat. Ann. § 3104; *Bank of Am., N.A. v. Gibson*, 102 A.3d 462 (Pa. Super. 2014)), it entitles the holder to enforce the obligation. 13 Pa. Cons. Stat. Ann. § 3109. A note is a negotiable instrument "if it 1) is payable to bearer or payable to order; 2) is payable on demand or at a definite time; and 3) does not require any other undertaking other than the payment of money." *Hellenic Capital, LLC v. Van Tran*, 2022 Pa. Super. 147 (2022) at 7. When a note is negotiated (i.e., when possession of the note is transferred), the type of indorsement made on the note may affect which party is deemed to be the holder under Pennsylvania law. A "holder of a note is a holder in due course if the note is a negotiable instrument that does not bear evidence of apparent forgery or alteration and the holder took it for value in good faith, without notice that it is overdue, has been dishonored, contains and unauthorized signature, or has

been altered, and without notice of any competing claim or defense to payment.” *Hellenic Capital, LLC v. Van Tran*, 2022 Pa. Super. 147 (2022) at 5-6. A holder in due course of a negotiable instrument is not subject to defenses of an obligor with whom the holder has not dealt, except for the defenses of infancy, duress, lack of capacity, illegality, fraud in inducing the obligor to sign the instrument without knowledge of the instrument’s essential terms, and discharge in insolvency proceedings. 13 Pa.C.S. § 3305(a)(1), (b). Section 3305(a) of the UCC provides that other contract defenses and defenses of recoupment for claims against the original payee arising from the same transaction may be asserted against holders of negotiable instruments who are not holders in due course. 13 Pa.C.S. § 3305(a)(2), (3). Section 3305(b), however, expressly provides that those other contract and recoupment defenses cannot be asserted against a holder in due course. 13 Pa.C.S. § 3305(b). Therefore, a breach of related agreements referenced in the negotiable instrument may not be a defense to a holder in due course. *Hellenic Capital, LLC v. Van Tran*, 2022 Pa. Super. 147 (2022) at 10.

The Pennsylvania Uniform Commercial Code distinguishes between a special indorsement and a blank indorsement:

- A special indorsement is one that is made by the holder of an instrument and identifies a person to whom the instrument is payable. 13 Pa. Cons. Stat. Ann. § 3205(a).
- A blank indorsement is an indorsement made by the holder of an instrument and does not specify that it is payable only to an identified person. 13 Pa. Cons. Stat. Ann. § 3205(b).

When a note is indorsed in blank, it “may be negotiated by transfer of possession alone until specially indorsed.” *Bank of N.Y. Mellon v. Bach*, 159 A.3d 16, 20 (Pa. Super. 2017) (quoting *JP Morgan Chase Bank, N.A. v. Murray*, 63 A.3d 1258, 1266 (Pa. Super. 2013)). “A note that is payable to the order of an identified person or payable to an identified person is payable to order.” *Hellenic Capital, LLC v. Van Tran*, 2022 Pa. Super. 147 (2022) at 7.

Pennsylvania courts have also held that “the chain of possession by which a party comes to hold [a] note is immaterial to its enforceability by the party.” *Bank of New York Mellon*, 159 A.3d at 20 (quoting *Gerber v. Piergrossi*, 142 A.3d 854, 862 (Pa. Super. 2016)); see generally *In re Walker*, 466 B.R. 271 (Bankr. E.D. Pa. 2012). Further, when a mortgage is assigned and the “assignment is effective, the assignee stands in the shoes of the assignor and assumes all of his rights.” *Citimortgage, Inc.*, 131 A.3d at 68. Lost notes are also enforceable in Pennsylvania under certain circumstances. See *MB Fin. Bank v. Rao*, 239 A.3d 181 (Pa. Super. 2020).

Default

A default is a failure to comply with an existing obligation. In the context of a loan, a default occurs when the borrower fails to repay the debt, including when it fails to timely pay principal, interest, and other charges that the loan agreement requires. A default can also occur when the borrower fails to comply with covenants in the loan agreement. The parties should ensure that all covenants and conditions in loan agreements are clear to avoid ambiguities that can lead to litigated disputes between the borrower and the lender. The loan documents may provide a process upon a default, such as the delivery of a notice of default, and a time period during which the borrower may cure the default. The lender may discover the default when the borrower fails to make a payment, when the borrower fails to deliver reporting information that it must produce periodically under the loan agreement, or when the lender receives other information about a covenant that the borrower has breached. Note that, usually, a borrower must notify the lender if it has knowledge of the existence of a default.

Most loan documents identify the conditions that give rise to events of default. The lender and the borrower compete in their negotiations over the breadth of the terms. Naturally, the lender wants broad terms of default to limit its risk of loss on the loan. The borrower, on the other hand, desires narrow terms to limit the lender’s ability to call a default and exercise its corresponding remedies, including the acceleration of the entire outstanding loan before its maturity date and the seizure of the collateral. Remedies for default may add attorney’s fees and liquidated damages to other forms of relief from the borrower, collateral, and guarantors.

Sometimes, an agreement states that time is of the essence for performance of a certain obligation, which means that the performance must occur by the given date. The lender should include time of the essence language in its loan agreement where it is imperative that the borrower perform certain of its obligations by the given date.

The loan documents may provide a cure period for a default, in which case the lender must give the borrower time to cure the default before pursuing relief. The parties should clearly specify cure rights in the loan documents to avoid ambiguity, which could lead to disputes between the borrower and lender. If the borrower does not timely cure the default, the lender may proceed and pursue its remedies. At that point, the lender may accept a late cure at its discretion and should evidence such acceptance with new documentation.

The loan documents may also require the lender to deliver a default notice to the borrower, in which case the cure period begins tolling upon delivery of the notice. The lender may state in the notice (1) the nature of the default and (2) that it

retains its right to exercise all other rights and remedies that may be available to the lender under the loan documents. The notice is meant to notify the borrower of the default and start any cure period, trigger the lender's available remedies, and avoid waiver of any other rights or remedies.

Borrower defaults are classified as either monetary or nonmonetary, as discussed below.

Monetary Defaults

A monetary default involves the failure to pay any of the obligations of the loan when they come due. This may occur when the borrower fails to pay interest, principal, or other amounts to the lender in accordance with the terms of the loan documents. The lender's counsel should make sure that the loan documents expressly state that time is of the essence for all payments due to the lender. Lenders typically hesitate to grant a notice and cure period for monetary defaults since a borrower knows well in advance when these payments are due. If a lender does grant a notice and cure period, it is typically brief (e.g., five days). If a lender refuses to provide notice, then the cure period runs from the date the payment was due. There may also be limits on the right to cure a monetary default, such as the number of times a borrower may cure a monetary default in any 12-month period. The loan documents should specifically state what protections, if any, are available to the borrower for such defaults.

Waiver issues can arise if the lender has regularly accepted less than strict performance of payment or other obligations under the loan documents. For example, if the lender has established a consistent pattern of accepting late payments, the lender may be deemed to have waived its right to expect strict compliance from the borrower and to accelerate the debt following a subsequent missed or late payment. When representing a lender, be sure to expressly limit such waiver positions in the loan agreement and, if your client has accepted late payments, advise your client to notify the borrower in writing that it is not waiving any of its rights or remedies and will not accept any further late payments.

Nonmonetary Defaults

A nonmonetary default is a default other than a monetary default. It typically occurs when a borrower fails to comply with a covenant or condition in the loan agreement. These covenants are often called affirmative covenants or negative covenants. Affirmative covenants are actions that the borrower must take, while negative covenants involve prohibitions on certain actions. For nonmonetary defaults, it is common for the loan agreement to require the lender to provide the borrower with notice and an opportunity to cure.

Affirmative covenants may include:

- Financial reporting involving the periodic delivery of financial performance information to the lender
- Complying with financial metrics (i.e., financial covenants)
- Maintaining SPE status
- Complying with applicable state, federal, and local laws and regulations
- Maintaining insurance, including for the real property
- Paying and complying with third-party obligations, such as real estate taxes and other debt
- Permitting the lender to physically inspect the premises and conduct environmental testing where appropriate
- Reporting extraordinary events, such as litigation or judgments and government enforcement actions

Negative covenants may prohibit the borrower, absent prior written approval from the lender, from performing various actions, including:

- Incurring additional debt
- Incurring additional liens, encumbrances, or judgments
- Selling or transferring property or assets of the business
- Selling or transferring ownership interests or changing corporate form or organization
- Experiencing extraordinary events, including the commencement of material litigation or government enforcement activity

A nonmonetary default can also occur if the borrower breaches a representation or warranty contained in the loan documentation. Typical representations and warranties include that:

- The borrower has the necessary right, power, and authority to enter into the loan documents
- The borrower holds the title to the property, free of liens and encumbrances other than as disclosed to the lender
- There are no material defaults on other indebtedness of the borrower
- The borrower holds all permits necessary to own, occupy, and operate the real property
- The real property securing the loan complies with all applicable laws and local ordinances

Financial Covenants

Financial covenants may include:

- **Debt service coverage ratio (DSCR).** The debt service coverage ratio, also known as the debt coverage ratio, is the ratio of annual net operating income (NOI) produced by the real property to annual debt service (i.e., interest

and any required principal amortization) due to the lender. When representing the borrower, you should negotiate to exclude loan receipts and payments from the calculation. Lenders may want to include debt service on subordinated debt in the calculation. Generally, a 1.15 to 1.35 DSCR ensures positive cash flow, a 1.0 DSCR is breakeven, and a DSCR below 1.0 signals a negative cash flow and loss under the debt structure.

- **Loan-to-value (LTV).** The loan-to-value ratio is the ratio of the outstanding loan amount to the appraised value of the property, expressed as a percentage. It is designed to ensure adequate collateral for the loan. In a typical commercial real estate loan, lenders will not allow the LTV to exceed 70%–80% LTV. Hard money lenders typically require an LTV below 60%.
- **Guarantor liquidity.** This covenant ensures that a guarantor is sufficiently liquid to pay off the debt. It may include financial metrics that are designed as tripwires to signal a coming default. At a set measuring point (e.g., quarterly, semiannually, or annually), the guarantor must hold a certain amount of cash and cash securities. The loan agreement should specifically state those assets that may be included to determine liquidity.
- **Debt yield.** The debt yield is simply a property's annual NOI divided by the outstanding loan amount, expressed as a percentage. Debt yield shows what the lender's cash-on-cash return on its money would be if it foreclosed on the property at that specific moment. Lenders use the debt yield ratio to evaluate the risk involved with the loan. As the debt yield rises, the risk of the loan drops. Generally, most lenders require a debt yield of at least 10%.

Organizational Status

Lenders often require a borrower to form a new SPE that is free of debts, obligations, and liabilities. The new SPE, which may be a subsidiary to a parent, enters into the loan transaction as the borrower and holds the collateral for the loan separate from the parent's other assets and subsidiaries. The lender can then set specific parameters for the use of the collateral and tie the financial metrics directly to the property and its business. The lender's counsel should run a title search for the subject property to ensure that it is properly titled in the name of the SPE, which will help insulate the lender's collateral from claims of the parent's creditors.

The loan agreement may include covenants to ensure that the borrower maintains the SPE's organizational status. Such covenants may require the borrower to:

- Limit the nature, purpose, and conduct of the business to solely acquire, own, hold, lease, operate, manage, maintain, improve, and operate the real property

- Observe all corporate formalities to ensure its separate existence
- Not commingle assets, including bank accounts, with other subsidiaries
- Clearly separate and segregate assets and business activities in its own name

For a detailed discussion of SPEs, see [Borrower as a Single Purpose Entity](#). For sample SPE representations, warranties, and covenants, see Article VI of [Loan Agreement \(Acquisition Financing\)](#).

Limitations on Additional Debt and Liens

A loan agreement typically includes negative covenants limiting the additional debt that the borrower may incur and the additional liens that it may grant on the subject property. The goal of these covenants is to limit the risk of default and minimize potential loss should a default occur. Note that in some situations, the lender may provide express written permission in the loan agreement for additional debt, such as subordinated financing (i.e., mezzanine financing) that is closed contemporaneously with the senior loan. This type of arrangement would be subject to an intercreditor agreement between the senior lender and the mezzanine lender. For further guidance, see [Commercial Real Estate Mezzanine Financings](#) and [Intercreditor Agreements \(Mortgage Lender and Mezzanine Lender\)](#).

Limitations on additional debt and liens help keep the borrower from becoming overextended and protect the lender and the collateral from other creditors. When representing the borrower, you should discuss the potential need for additional indebtedness and liens with your client to negotiate the appropriate carve-outs in the loan documentation.

Transfers

To help ensure that the property operates and generates revenue in a manner consistent with the loan's underwriting, operational control of the borrower should remain with qualified parties known to the lender. Lenders often include provisions in the loan agreement prohibiting transfers of ownership and management of the borrower except in limited circumstances. Lenders also typically require that the borrower include provisions to this effect in its organizational documents. The parties may, of course, agree on carve-outs to permit certain transfers. When representing a borrower, you should discuss any anticipated transfers with your client and negotiate any necessary carve-outs.

Leases

In commercial real estate transactions, rents from tenants may be the borrower's primary source of revenue. Thus, new leases and amendments to or terminations of existing leases

may require the lender's consent. Alternatively, the loan agreement may set forth preapproved leasing guidelines and standard lease forms.

Cross-Default and Cross-Collateralization Clauses

Cross-default provisions put the borrower in default if the borrower defaults on another loan. These clauses may include monetary and nonmonetary defaults as defined in the loan agreement and debt from other lenders. This is a way to limit risk to the lender; if the borrower cannot fulfill its obligations under one loan agreement, it is likely to default on others.

If the borrower has multiple loans with the lender, the loan agreement may provide for cross-collateralization, where one or more assets serve as collateral for multiple loans. This permits the lender to pursue any of the assets upon a default. A cross-collateral clause is also sometimes called a dragnet clause. Although they are disfavored in connection with real estate because they can cloud title, dragnet clauses are enforceable in Pennsylvania if future advances are related to the purposes of the original loan agreement. See *D'Angelo v. Blue Chip Fed. Credit Union (In re D'Angelo)*, 524 B.R. 624, 631–32 (Bankr. M.D. Pa. 2015) (discussing the "Relatedness Rule").

Material Adverse Change (MAC) Clauses

MAC clauses are designed to disclose changes in the borrower or property that would negatively impact the borrower's financial or operational condition. Where a financing involves multiple drawdowns on the loan, the lender may require affirmative MAC representations for each drawdown. An example of a MAC clause is as follows:

"Material Adverse Change" means a material adverse change in (a) the condition (financial or otherwise), operations, assets, liabilities, business, or prospects of the borrower; or (b) the ability of the Borrower to repay the debt or to perform its obligations under the loan documents; or (c) the rights and remedies of the lender under the loan documents; or (d) the legality, validity, or enforceability of any loan document; or (e) the liens granted the lender pursuant to the loan documents.

Additional elements may include changes in the ownership of the borrower and changes to the collateral securing the loan. The loan agreement may provide for the right to cure following a default under the MAC clause.

Representations and Warranties

Commercial loan agreements generally always contain representations and warranties. A representation is a statement of fact that relates to a past or existing fact, and a warranty promises that existing or future facts are or will be true. The borrower makes representations and warranties as of the closing date and restates them when requesting additional drawdowns.

The borrower's representations and warranties are intended to induce the lender to make the loan to the borrower by establishing the borrower's ability and intent to repay the loan. The lender's representations are generally limited to confirming that the lender is properly formed and has the authority to make the loan. The parties may set forth exceptions in a schedule and include knowledge qualifiers where appropriate.

Loan Workouts

A loan workout is a plan to restructure the debt to avoid the lender's remedies upon a default and allow the loan to continue performing. A workout requires mutual agreement between the lender and the borrower and may include a renegotiation of loan terms (such as a reduced interest rate and deferred or waived arrearages), a waiver of borrower defaults, and a release of claims of the borrower against the lender.

The loan workout may also include a forbearance agreement, in which a lender agrees not to exercise its remedies under the loan agreement for a specified period of time—so long as the borrower meets certain conditions, such as curing defaults and continuing debt service payments, and agrees to loan document modifications—while retaining its security interests in the collateral. A forbearance agreement may be appropriate if the lender believes that, despite an event of default, the borrower should remain in control of the real property. The failure of a loan workout may result in the lender exercising its remedies.

When preparing a loan workout, counsel to both parties should assemble all of the relevant documents relating to the loan. Counsel should be sure to preserve information in the event of litigation and to prevent spoliation claims. Additionally, during the loan workout process, the parties should identify and correct missing items and signatures or errors in the loan documentation. The lender's counsel should also investigate and confirm perfection and priority of liens.

Before any workout discussions commence, the lender should require the borrower and guarantors to enter into a pre-negotiation agreement. Pre-negotiation agreements protect the lender from claims that the parties reached a workout agreement contrary to the lender's intention. Pre-negotiation agreements should acknowledge existing defaults and preclude the admission or binding nature of communications that the parties made during the negotiation.

In that regard, the parties should consider the effect of state and federal laws governing electronic transactions, including the Uniform Electronic Transactions Act (UETA), which 47 states (including Pennsylvania) and Washington, DC, Puerto Rico, and the Virgin Islands have adopted in some form.

Under the UETA, many contracts that must be in writing and signed by the parties under the statute of frauds or otherwise may be signed electronically and carry the same weight as if signed in person.

Courts have found that an email can satisfy the legal requirement that a record be in writing and a signature line can constitute an electronic signature. See also *Bethel v. Heller*, No. 2018-7211 (Mont. C.C.P. Mar. 7, 2022) at 14 (requirement of a writing can be satisfied by email exchanges). The parties may modify or waive these provisions by agreement and should consider including such a waiver in a pre-negotiation agreement to avoid uncertainty over the effect of email communications. In addition, the pre-negotiation agreement should provide that the lender may continue to enforce its remedies until the parties execute an agreement, which may prevent the borrower from claiming that the lender promised and is obligated to modify or extend the loan and is estopped from enforcing its remedies. For further information on pre-negotiation agreements, see [Workouts of Commercial Real Estate Loans](#). For a pre-negotiation agreement template, see [Pre-Negotiation Agreement \(Commercial Real Estate Acquisition Loan\)](#).

The workout negotiation should include sufficient information-sharing to enable the lender to determine how to properly resolve a default. The lender should confirm the present value of the real property and inspect the financial and operating books and records of the business to evaluate the strengths and weaknesses of the borrower and its management. In exchange for extending accommodations to the borrower, the lender should also consider requiring additional collateral, such as:

- Liens on unencumbered assets
- Second liens on encumbered assets
- Profits interests
- Equity interests
- Stock pledges

Further, the lender may wish to require a landlord waiver to grant the lender rights to enter the borrower's leased premises, and a deposit account control agreement to give the lender control over the borrower's accounts in connection with a further default. The lender should obtain releases of claims as well to avoid defensive litigation and consider a confession of judgment clause to the extent the existing loan documents do not already include one.

For a detailed discussion of workouts, see [Workouts of Commercial Real Estate Loans](#).

Lender Remedies

Overview of Lender Remedies

Following default and any failed loan workout attempts, the procedures set forth in the loan documents and Pennsylvania law will determine the remedies available to the lender. These remedies are not exclusive and may include:

- Acceleration
- Setoff
- Lawsuit on the loan agreement
- Foreclosure on the mortgage
- Receivership
- Settlement of the debt and transfer of the collateral to the lender by deed in lieu of foreclosure

Contractual Remedies

The loan agreement typically sets forth the lender's contractual remedies. If the transaction does not include a separate loan agreement, the contractual remedies should appear in the mortgage. Pennsylvania courts will generally enforce the terms of a commercial mortgage contract, including its remedies. See *Metro Life Ins. Co. v. Liberty Ctr. Venture*, 650 A.2d 887, 890 (1994).

These contractual remedies, which arise upon a default and may require notice to the borrower, often include:

- **Charging default interest.** The default rate of interest is an increase over the stated rate of interest set forth in the loan documents. Note that Pennsylvania's Loan Interest and Protection Law, beginning at 41 Pa. Stat. Ann. § 201, sets usury limits for consumer loans but does not apply to commercial transactions. While Pennsylvania has no interest rate cap on business loans, other states, including New Jersey, New York, Texas, and California, do.
- **Imposing late charges.** In addition to charging default interest, a lender will often impose a late charge as a way to compensate the lender for a late payment under the loan. The late charge is typically calculated as a percentage of the missed payment.
- **Accessing collateral accounts.** A cash management and account control agreement can provide additional security by allowing the lender to access the borrower's cash before pursuing other remedies. The agreement typically requires revenue deposits into a restricted account and sets forth the terms of distribution. It may also include a lockbox provision requiring tenants to pay rent directly into a specified account. There are various lockbox forms, including a hard lockbox, which requires tenants to pay rent directly to a lender-controlled account; a soft lockbox, which allows the borrower to collect rents but

requires the borrower to deposit rents into the lender's account after an event of default; and a springing lockbox, which requires payments into the lender's account after an event of default or other triggering event. The borrower pledges the lockbox to the lender consistent with 13 Pa. Cons. Stat. Ann. § 9312 and § 9314.

In addition, the lender's contractual remedies may include accelerating the entire indebtedness and permitting automatic setoff against funds of the borrower that the lender holds, as further discussed below.

Note that loan agreements also often impose prepayment penalties or premiums if the borrower prepays all or a portion of its obligations ahead of the maturity date. Pennsylvania courts have held that where the "mortgage note is silent as to the right of prepayment, there arises a presumption that the debt may be prepaid." See *Mahoney v. Furches*, 468 A.2d 458, 461 (Pa. 1983). It is permissible for the loan agreement to require the borrower to remit a prepayment premium upon an early payoff. See *Chestnut Corp. v. Bankers Bond & Mortg. Co.*, 149 A.2d 48, 50 (Pa. 1959).

Doctrine of Merger

The holder of a note and mortgage can proceed in rem or in personam to recover the unpaid obligation. Further, the lender may proceed by an action of mortgage foreclosure or by an action on the note that the mortgage secures. Under the doctrine of merger, the terms of the note and mortgage may merge into a judgment in mortgage foreclosure, which can preclude the assessment of certain post-judgment items:

[A]fter the entry of a foreclosure, the terms of a mortgage are merged into the foreclosure judgment and the mortgage no longer provides a basis for determining the respective rights and obligations of the parties. Because the foreclosure judgment constitutes a "new and higher" obligation, mortgage provisions relating to items such as the interest rate and the borrower's obligation to reimburse the lender for advances for taxes and insurance are superseded by the judgment and are no longer operative.

See *In re Smith*, 463 B.R. 756, 761 (Bankr. E.D. Pa. 2012).

The superior court decision in *EMC Mortg., LLC v. Biddle*, 114 A.3d 1057 (Pa. Super. 2015) explains whether particular borrower obligations and charges merge into the foreclosure judgment and are extinguished, or whether, due to certain contractual exceptions, they do not merge and instead survive the entry of judgment as ongoing borrower obligations. The Bankruptcy Court in *In re Culler*, 584 B.R. 516 (Bankr. E.D. Pa. 2018) applied this guidance to a variety of post-judgment items, including interest, fees, and other charges, and found those that may be allowed under the contract exception to the merger doctrine.

Acceleration

The loan agreement should include an acceleration clause, which allows the lender to call the loan. The effect is to fully mature the performance due from the borrower upon its default and immediately demand payment in full of all amounts due. The loan agreement and mortgage should set forth the form and manner of any notice of acceleration. Acceleration can result from either a monetary or a nonmonetary default. While Pennsylvania statutory law prescribes the acceleration process for residential mortgages, there is no statutory overlay for commercial mortgages. However, the lender should be sure to strictly follow all contractual notice obligations to effectuate acceleration.

As mentioned above, the lender may unintentionally waive the right to accelerate a loan if it has failed to act on prior, similar events of default. In addition, a court may deem that the lender waived an acceleration from post-acceleration conduct, such as accelerating a loan and later accepting a payment, representing that the borrower can bring the loan current by making a payment of less than the entire obligation or requesting payment on less than the full amount of the loan after acceleration, and sending an additional notice of acceleration or other communication from which the borrower could infer that the lender abandoned a previous notice.

Setoff

The loan agreement may include a setoff provision, which allows the lender to seize a borrower's deposits and accounts when it defaults on a loan to repay the obligation. The provision may also refer to a settlement of mutual debt between the lender and the borrower through offsetting transaction claims.

Under Pennsylvania common law, a bank is deemed to have a general lien upon or right of setoff against the funds in its possession belonging to a depositor to secure the depositor's indebtedness to the bank:

Immediately upon the maturity of a debt owed by a depositor, the bank's right to set-off, by operation of law, extinguishes the depositor's rights to the account. Set-off is not overridden by the filing or service of attachment execution or garnishment. In effect, the garnishee-bank's common law right to set-off gives it a right to self-help that takes priority over other creditors claiming a right to the funds on deposit. Set-off, however, is appropriate only where certain conditions are met. There must be mutuality of obligation between the bank and the depositor; the funds against which set-off is exercised must belong to the depositor; the funds must be deposited with the bank into a general account; and, the debt owed by the depositor to the bank must be mature.

See *Royal Bank v. Selig*, 644 A.2d 741, 744 (1994) (internal citations omitted).

The lender's right to setoff may extend to the borrower's operating accounts if the lender holds them, which could effectively terminate the borrower's business. Note that the borrower may have a claim against the lender if the lender improperly accelerated the loan resulting in the destruction of the borrower's business or the takeover of collateral. See generally *Pioneer Commercial Funding Corp. v. American Financial Mort. Corp.*, 855 A.2d 818 (Pa. 2004).

Lawsuit on the Loan Agreement or Foreclosure on the Mortgage

A mortgage is a security instrument to ensure payment of the note. See *CitiMortgage, Inc. v. Barbezat*, 131 A.3d 65, 68 (Pa. Super. 2016). "When a note is paid, the mortgage expires." *Id.* Conversely, "[t]he lien of a mortgage continues until the mortgage debt is paid." *Beckman v. Altoona Tr. Co.*, 2 A.2d 826, 828 (Pa. 1938).

A lender may sue on a recourse loan for a money judgment against the borrower. Pennsylvania law does not require that the lender first foreclose on the mortgage. See *Levitt v. Patrick*, 976 A.2d 581, 592 (Pa. Super. 2009). However, Pennsylvania courts may deem the release of a promissory note to also release the mortgage that secures the same obligation, and vice versa. See *Purman's Estate*, 5 A.2d 906, 907 (Pa. 1939). Consideration of the assets available to satisfy the indebtedness will determine the best route of recovery for the lender (i.e., through a foreclosure on the mortgage or suit on a recourse loan).

Thus, when the borrower defaults on payments, "[t]he holder of a mortgage note can decide whether to file a foreclosure action or to file an in personam assumpsit action on the note[.]" *Nicholas v. Hofmann*, 158 A.3d 675, 696 (Pa. Super. 2017).

In either event, the party prosecuting the action must be the real party in interest. See *Pa. R.C.P. 2002(a)*. In a mortgage foreclosure action, the real party in interest is the mortgagee. See *Gerber v. Piergrosi*, 142 A.3d 854, 859 (Pa. Super. 2016). "The foreclosing party can prove standing either by showing that it (1) originated or was assigned the mortgage, or (2) is the holder of the note specially indorsed to it or indorsed in blank." *Id.* at 859-60. When proceeding on the mortgage instrument, the mortgagee must nonetheless also have "the right to make demand upon the note secured by the mortgage." *Barbezat*, 131 A.3d at 68. The mortgagee must "own or hold the note." *MB Fin. Bank v. Rao*, 201 A.3d 784, 790 (Pa. Super. 2018).

Statute of Limitations

A lawsuit on the loan agreement is in the nature of a breach of contract and must be commenced within the

applicable statute of limitations for contract claims, which in Pennsylvania is four years. See 42 Pa. Cons. Stat. Ann. § 5525(a).

If, however, the operative agreement is an instrument under seal, the limitations period is 20 years. See 42 Pa. Cons. Stat. Ann. § 5529(b). To designate the instrument as being under seal, the parties should place the word "seal" next to the signature line. See *Beneficial Consumer Disc. v. Dailey*, 644 A.2d 789, 790 (1994); see also *Driscoll v. Arena*, 213 A.3d 253, 259-60 (Pa. 2019). Alternatively, reference to sealing may be made in a recital above the parties' signatures (see *National Loan Investors, L.P. v. Gold*, 242 A.3d 411 (Pa. Super. 2020)), or in the notary's acknowledgment (see *Valley Nat'l. Bank v. Marchiano*, 221 A.2d 1220 (Pa. Super. 2019)). "Whether an instrument is under seal or not is a question of law for the court, and whether a seal placed on an instrument has been adopted by the maker as his seal is a question of fact." *Swaney v. Georges Tsp. Rd. Dist.*, 164 A.3d 336, 337-38 (Pa. 1932). While the term "instrument" is not defined under the Pennsylvania Judicial Code, courts have held that a written guaranty may be deemed an instrument falling within this extended statute of limitations period. See *Osprey Portfolio, LLC v. Izett*, 67 A.3d 749 (Pa. 2013). Oral modifications of payment arrangements for an agreement under seal, which can defer the limitations period, are legal when they do not take or confer any interest in the land, but rather only determine the time when the money comes due. See *Novice v. Alter*, 139 A. 590, 592 (Pa. 1927).

Pennsylvania courts have long held that the statute of limitations extinguishes only the right of action on a debt, and not the underlying debt itself, such that "[t]hough a note may be barred by the statute of limitations from recovery in an action against the maker, collateral given as security for its payment may still be applied to the note." *In re Anthracite Tr. Co. of Scranton*, 36 A.2d 727, 729 (Pa. Super. 1944); see also *Brackenridge v. Cummings*, 18 Pa. Super. 64, 68 (Pa. Super. 1901). Thus, the fact that the statute of limitations may have expired for an action to obtain an in personam judgment on the note does not affect standing to obtain an in rem judgment against the collateral that secured the unpaid debt. See *National Loan Investors, L.P. v. Gold*, 242 A.3d 411 (Pa. Super. 2020).

Foreclosure on the Mortgage

A foreclosure is a process to recover the outstanding indebtedness through an in rem judgment that leads to a sheriff's sale of the mortgaged property. Foreclosures are judicial in Pennsylvania, which means that the foreclosing lender must file a lawsuit in court and follow the rules for foreclosure. (This differs from the nonjudicial foreclosure process governed by power of sale clauses in a security deed, which is prevalent in many other states.) Foreclosures

allow the lender to sell the collateral property and apply the proceeds after costs to the outstanding debt. Under the foreclosure judgment, the debt of the loan agreement or note merges into the foreclosure judgment.

The Pennsylvania Rules of Civil Procedure govern foreclosure actions and require a relatively limited complaint (see Pa. R.C.P. 1143), filed in the county of the subject property (see Pa. R.C.P. 1142), for one cause of action for foreclosure (see Pa. R.C.P. 1146). The foreclosure may proceed to trial without a jury (see Pa. R.C.P. 1150), with judgment entered and execution to proceed through the writ of execution and sheriff's sale process.

A prima facie case for foreclosure is established when execution, recording, and non-payment are conceded. See *Bank of America, N.A. v. Gibson*, 102 A.2d 462, 464 (Pa. Super. 2014); *Landau v. Western Pennsylvania Nat'l Bank*, 282 A.2d 335, 340 (Pa. 1971) (summary judgment in a mortgage foreclosure action is proper when (1) default has occurred, (2) interest on the obligation has not been made, and (3) the recorded mortgage is in a specified amount). Summary judgment is appropriate "even if the mortgagors have not admitted the total amount of indebtedness in their pleadings." *Cunningham v. McWilliams*, 714 A.2d 1054, 1057 (Pa. Super. 1998).

The "purpose of a sheriff's sale in mortgage foreclosure proceedings is to realize out of the land, the debt, interest, and costs which are due, or have accrued to, the judgment creditor." *Kaib v. Smith*, 684 A.2d 630, 632 (Pa. Super. 1996). If the proceeds from the sheriff's sale fail to satisfy the outstanding indebtedness, the lender may pursue a deficiency judgment through a petition under 42 Pa. Cons. Stat. Ann. § 8103 and Pa. R.C.P. 3276–3291. The lender must commence the action for deficiency judgment within six months from the sheriff's delivery of the deed. See 42 Pa. Cons. Stat. Ann. § 5522(b). The Pennsylvania Deficiency Judgment Act (DJA) applies "whenever real property has been sold in execution for a sum less than the amount of the judgment, interest and costs." 42 Pa.C.S. § 8103(a). "If no petition to fix the fair market value of the property is timely brought by the creditor, the judgment in favor of the creditor is satisfied, released and discharged as a matter of law." *First Nat. Cons. Disc. Co. v. Fetherman*, 527 A.2d 100, 105 (Pa. 1987). Failure to timely proceed under the DJA "raises as a matter of law the conclusive presumption that the judgment has been satisfied." *Home Sav. & Loan Co. of Youngstown, Ohio v. Irongate Ventures, LLC*, 19 A.3d 1074, 1080 (Pa. Super. 2011). A motion to fix fair market value under the DJA must be filed in the foreclosure action. *Id.* at 1079. In the context of a bankruptcy, to ensure that the debtor receives credit for the fair market value of the foreclosed property, the six-month time period for the commencement of a deficiency

judgment action does not lapse until six months after termination of the automatic stay under Section 362 of the Bankruptcy Code (11 U.S.C. § 362). See *In re Zinchiak*, 280 B.R. 117 (Bankr. W.D. Pa. 2002).

A petition to set aside the sale must be filed before the sheriff delivers the deed to the property. See Pa. R.C.P. 3132; see also *Capozzi v. Antonoplos*, 201 A.2d 420 (1964). A petition to set aside the sale is grounded in equitable principles. *LSF8 Master Participation Trust v. Petrosky*, 271 A.3d 1288, 1291 (Pa. Super. 2022).

For further information on the foreclosure process in Pennsylvania, see [Foreclosure Resource Kit \(PA\)](#) and [Mortgage Foreclosure Litigation \(PA\)](#).

Judgment Liens

The judgment for the payment of money forms a lien on all of the borrower's real property located in the county that the state court has jurisdiction over. See 42 Pa. Cons. Stat. Ann. § 4303(a). (Note that in the case of federal court, the lien covers the borrower's real property in the county where the federal courthouse sits.) The judgment lien is a protectible property interest, forming a hold on all of the borrower's real estate within the territorial jurisdiction of the court and permitting a forced judicial sale of the land to satisfy the judgment debt. See *PNC Bank, Nat'l Ass'n v. Balsamo*, 634 A.2d 645, 656 (1993). See generally *Valley Cmty. Bank ex rel. Osprey Portfolio, LLC v. O'Malley*, 2014 Pa. Super. Unpub. LEXIS 832 (June 25, 2014). A judgment must be revived every five years to maintain its lien position. 42 Pa. Cons. Stat. Ann. § 5526(1).

The lender executes on the judgment through a writ of execution that directs the sheriff (or the U.S. Marshal, if the case is in federal court) to garnish accounts or other property that is in the hands of another person. The writ of execution can also direct the sheriff to sell the property at sheriff's sale. The Pennsylvania Rules of Civil Procedure govern the process of the writ of execution and sheriff's sale. See Pa. R.C.P. No. 3101–3159 (money judgment); Pa. R.C.P. No. 3180–3183 (mortgage foreclosure); and Pa. R.C.P. No. 2956.1–2958.3 (confessed judgment). Note that postponing a sheriff's sale, rather than staying the sale, allows the executing lender to avoid the expense of re-advertising the sale. See *Billings v. Portnoff Law Assocs. (In re Billings)*, 544 B.R. 529, *aff'd.*, 2016 U.S. Dist. LEXIS 75713. The duration and number of postponements are limited absent a special order of the court. See Pa. R.C.P. No. 3129.3.

In addition to generating a payoff in whole or in part if another party purchases the property at the sale, the sheriff's sale can remove junior liens on the property that may have attached after the lender's lien. Each county may have its own distinct style of sheriff's sales. The lender's counsel should

confirm the county's deadlines, bidding procedures, and rules of conduct at the sale, including in connection with the announcement of the upset price and registration of the bid of the executing creditor.

Guarantor Considerations

Similar considerations and claims apply to a suit against a guarantor under a guaranty. The lender may seek collection in any order unless the loan agreement provides otherwise, and there is likewise no requirement to enter judgment against the borrower before the guarantor. See *Penn State Mut. Ins. Co. v. Burglar's Enemy, Inc.*, 397 A.2d 10, 11–12 (1979); cf. *Levitt v. Patrick*, 976 A.2d 581 (Pa. Super. 2009) (notwithstanding such flexibility, double recovery from a judgment execution and a foreclosure is not permissible). Moreover, courts presume that, when two or more parties enter into a covenant or undertake an obligation, the parties have agreed to be jointly—and not severally—bound to the terms of the contract. See *Mintz v. Tri-County Nat. Gas Co.*, 103 A. 285, 286 (Pa. 1918). This presumption will not hold, however, where the intention of the parties, evident in the language of the contract, reveals otherwise. *Id.* Note that a non-recourse carve-out guaranty may limit the guarantor's liability to loss liability (i.e., the amount of actual losses the lender incurred due to the carved-out risk) or call for full loan liability (i.e., the entire amount of the outstanding indebtedness).

A party that is solely a guarantor may not have standing to sue for or raise defenses for breaches of the underlying contract. See *Borough of Berwick v. Quandel Group*, 655 A.2d 606 (Pa. Super. 1995); *PB Warminster Plaza LLC v. Roth*, Pa. Bucks C.C.P., No. 2021-707-37 (Nov. 17, 2021).

Confession of Judgment

Under a confession of judgment clause, one party to the contract authorizes the entry of judgment against itself upon certain events of default. A confession of judgment is illegal in consumer transactions in Pennsylvania and elsewhere pursuant to the Credit Practices Rule of the Federal Trade Commission, which went into effect March 1, 1985. Similar rules have been passed by the Federal Reserve Board and the Federal Home Loan Bank Board for banks, savings and loan associations, and other institutions under their jurisdiction. Confessions of judgment are generally permitted, however, in commercial transactions in Pennsylvania. A properly executed warrant of attorney to confess judgment grants the plaintiff creditor in Pennsylvania an immediate judgment against the defendant debtor without prior notice or an opportunity to be heard. Indeed, Pennsylvania generally offers an easier process to confess judgment with broader relief and fewer defenses than other states. See, e.g., New York's Section 3218 of the Civil Practice Law and Rules (N.Y. C.P.L.R. 3218)

(generally precluding confessions of judgment against out-of-state obligors and limiting entry of judgment within three years of execution). Increasing restrictions on confessed judgments in other states such as New York are leading more commercial creditors to pursue relief in Pennsylvania courts.

For a confession of judgment clause to be effective, the agreement must state it clearly. Pennsylvania courts strictly construe confessions of judgment as a matter of public policy. Therefore, a warrant must be “strictly construed against the party in whose favor it is given.” *Landow v. Bailing*, 169 A. 780, 781 (Pa. 1934). Specific rules in the Pennsylvania Rules of Civil Procedure, starting with Rule 2950 (Pa. R.C.P. No. 2950), govern the form and content of the complaint to confess judgment, as well as the petition that a defendant may file in response to open or strike the confessed judgment. Under Pennsylvania law, the court must enter a confessed judgment in rigid adherence to its terms. See *Dollar Bank v. Northwood Cheese Co.*, 637 A.2d 309, 311–12 (1994). Indeed, when an obligor subject to a warrant of attorney for confession of judgment dies, judgment cannot be legally entered against the obligor or his or her estate. See *First Fed. Sav. & Loan Assn. v. Porter*, 183 A.2d 318, 322 (1962); cf. *Commonwealth v. Buhler*, 2019 Pa. Commw. Unpub. LEXIS 382 (Pennsylvania “courts seem to permit creditors to confess judgment against surviving obligors regardless of the type of [joint and several or joint] liability imposed by the underlying contract.”).

A confession of judgment on the obligation accompanying a mortgage is a proceeding in personam, as opposed to the in rem mortgage foreclosure against the real property. This judgment is not limited to the property that is subject to the mortgage. Rather, it is a general lien on all real property that the judgment debtor owns within the court's territorial jurisdiction at the time of the judgment. See *Bank of Pa. v. G/N Enters., Inc.*, 463 A.2d 4, 6 (1983). If the property subject to the lien of the judgment is identical to the property that the mortgage secures, then the lien of the judgment may relate back to the date on which the mortgage was recorded. *First Fed. Sav. & Loan Assn.*, 183 A.2d at 323. This means that the mortgaged property remains security for the repayment of the obligation even after a transfer of title; a transferee contesting the property's sale under a writ of execution may raise only those defenses set forth in the Pennsylvania Rules of Civil Procedure for the enforcement of judgments. See *Bank of Pa.*, 463 A.2d at 7.

In addition to allowing for entry of a judgment for money, a confession of judgment on the mortgage can permit an entry of judgment for possession of the mortgaged property. The standards and process for a confession of judgment for possession are generally the same as those for a confession of judgment for money.

The confession of judgment process can be an effective and efficient way to resolve a dispute or a default and circumvent protracted court proceedings. Under Pennsylvania law, the court will strike a judgment entered by confession only when a fatal defect or irregularity appears on the face of the record. See *Resolution Tr. Corp. v. Copley Qu-Wayne Assocs.*, 683 A.2d 269, 273 (1996). To open a confessed judgment, the judgment debtor must raise a meritorious defense and present sufficient evidence that is clear, direct, precise, and believable. See *First Seneca Bank & Tr. Co. v. Laurel Mountain Dev. Corp.*, 485 A.2d 1086, 1088 (Pa. 1984). In addition, “when a defendant contests the amount confessed by plaintiff, the burden remains upon the defendant to disprove that amount, even where that amount is listed in a single lump-sum.” See *Berkshire Bank v. Turtle Time JRP 2, LLC*, 2020 Phila. Ct. Com. Pl. LEXIS 16 (May 11, 2020) (denying petitions to open or strike confessed judgment); see also *Rait Partnership, L.P. v. E Pointe Properties I, LTD*, 957 A.2d 1275 (Pa. Super. 2008).

The state court-confessed judgment is considered a final judgment covered by the *Rooker-Feldman* doctrine, which holds that federal district courts lack jurisdiction over suits that are essentially appeals from state court judgments. As a result, regardless of whether or not the defendant has filed a petition to strike or open the confessed judgment, the case cannot be removed to federal court. See *Complete Bus. Sols. Grp. v. Sunrooms Am.*, No. 20-847, 2020 U.S. Dist. LEXIS 130239 (E.D. Pa. July 22, 2020).

A commercial lender may confess judgment multiple times against a personal guarantor using the same warrant of attorney when the clause contains explicit language allowing the lender to reuse it. See *SDO Fund II D32, LLC v. Donahue*, 234 A.3d 738 (Pa. Super. 2020) (multiple amendments to the original note with explicit ratifications of the continuing guarantee and warrant of attorney permitted subsequent confession of judgment). Cf. *Bethel v. Heller*, No. 2018-7211 (Mont. C.C.P. Mar. 7, 2022) at 13 (“The law in Pennsylvania is clear that where judgment has been entered by confession, the note and claim upon which judgment was confessed are merged in the judgment. Thus, the cause of action evidenced by the note is vitiated and the judgment then represents a new obligation.”).

Under Rule 2959 of the Pennsylvania Rules of Civil Procedure (Pa. R.C.P. No. 2959), the confessed judgment remains in full force and effect even while a petition to strike or open is pending, and the “lien of the judgment or of any levy or attachment shall be preserved while the proceedings to strike off or open the judgment are pending.” Thus, absent a stay from the court, the judgment is immediately available for execution, which may generate liens and levies that will remain effective throughout any further proceedings. While

not all states permit confessed judgments, they generally must accept the transfer of such a judgment under the Full Faith and Credit Clause of the U.S. Constitution. The court may add attorney’s fees of up to 15% to the judgment if the warrant so specifies. See *Dollar Bank*, 637 A.2d at 314.

For these reasons, a warrant of attorney authorizing judgment has been called “perhaps the most powerful and drastic document known to civil law. The signing of a warrant of attorney is equivalent to a warrior of old entering a combat by discarding his shield and breaking his sword.” See *Cutler Corp. v. Latshaw*, 97 A.2d 234 (Pa. 1953). Because of this, “the law jealously insists on proof that this helplessness and impoverishment was voluntarily accepted and consciously assumed.” *Id.*

For more information on confessions of judgment in Pennsylvania, see [Commercial Real Estate Financing Transactions \(PA\)](#).

Defenses

The borrower’s defenses to the lender’s suit on the loan agreement will depend on the circumstances of the loan but might include:

- Dispute over the default or the notice of default
- Estoppel or waiver based on repeated action or inaction, or communications from the lender to the borrower that induced action or inaction
- Lack of standing if the lender transferred the loan
- Dispute over one or more payments
- Expiration of the statute of limitations
- Wrongful acceleration of the outstanding debt
- ECOA violation due to the addition of a spouse’s guaranty

Similar arguments may involve adhesion or unconscionable contracts or terms. A contractual term may be “unconscionable, and therefore avoidable, where there was a lack of meaningful choice in the acceptance of the challenged provision and the provision unreasonably favors the party asserting it.” *Salley v. Option One Mortg. Corp.*, 592 Pa. 323, 331 (2007). Generally, “a contract is procedurally unconscionable if the contract was obtained through ‘oppression’ or ‘unfair surprise.’” *Witmer v. Exxon Corp.*, 495 Pa. 540, 551 n.16 (1981). A contract “is substantively unconscionable if it “unreasonably favors the party asserting it.” *Salley*, 592 Pa. at 331. However, in Pennsylvania, a “person of age is presumed to know the meaning of words in a contract, and if, relying upon his own ability, he enters into an agreement not to his best interests he cannot later be heard to complain that he was not acquainted with its contents and did not understand the meaning of the words used in the instrument which he signed.” *Schoble v. Schoble*, 349

Pa. 408, 411-12 (1944). Therefore, in the “absence of proof of fraud, the failure to read a contract before signing it is an unavailing excuse or defense and cannot justify an avoidance, modification or nullification of the contract; it is considered supine negligence.” *Germantown Sav. Bank v. Talacki*, 441 Pa. Super. 513, 521 (Pa. Super. 1995). See also *Denlinger, Inc. v. Dendler*, 415 Pa. Super. 164 (Pa. Super. 1992) (application for credit in corporate name and signature in corporate capacity insufficient to alter express terms of corporate debt instruments imposing personal liability); *Angino & Rovner, P.C. v. Sovereign Bank, N.A.*, No. 13-1563, 2014 Pa. Dist. & Cnty. Dec. LEXIS 970 at *11 (Berks CCP May 14, 2014) (“Plaintiffs defaulted on their loans, so they may not have been in a strong bargaining position, but they were never coerced to sign any documents. ... [A] Bank does not have to loan plaintiffs more money when they are having trouble paying off their present loans. A bank is a business and giving money to poor credit risks is not a good business practice.”).

Fraudulent inducement defenses or claims can also arise. To plead a claim for fraudulent inducement, a plaintiff must demonstrate the following elements: (1) a representation by the defendant; (2) which is material to the transaction at hand; (3) made falsely, with knowledge of its falsity or recklessness as to whether it is true or false; (4) with the intent of misleading another; (5) justifiable reliance; and (6) damages. *Eigen v. Textron Lycoming Reciprocating Engine Div.*, 874 A.2d 1179, 1185 (Pa. Super. 2005).

Likewise, a party to a written contract may seek reformation based upon a mutual mistake. “Mutual mistake regarding an essential term of a contract may provide a basis for the contract’s rescission if (1) the mistake relates to an essential fact which formed the inducement to [the contract]; and (2) the parties can be placed in their former position with reference to the subject-matter of [the contract].” *Murray v. Willistown, Twp.* 169 A.3d 84, 90 (Pa. Super. 2017). This equitable remedy of reformation is also available where bad faith, accident, or mutual mistake can be shown, and in the case of unilateral mistake, the party against whom reformation is sought must be shown to have knowledge of the mistake sufficient to justify an inference of fraud or bad faith. *Regions Mortgage, Inc. v. Muthler*, 889 A.2d 39, 42 (Pa. 2005). However, “a court will not reform a written contract so as to make a contract for the parties that they did not make themselves.” *Id.* at 94. Such claims are subject to a heightened pleading standard. *Regscan, Inc. v. Con-Way Transp. Servs.*, 875 A.2d 332, 340 (Pa. Super. 2005). Claims for fraud or reformation based upon an alleged failure to read a commercial contract are generally unavailing. See *Caterpillar Fin. Commer. Account Corp. v. East Coast Paving & Seal Coating*, 2013 Pa. Dist. & Cnty. Dec. LEXIS 393 at *6 (Lawrence CCP Aug. 8, 2013 (“Failure to read a contract does not give rise to a cause of action for fraud”)); *Villella*

v. Katzen, 2001 Pa. Dist. & Cnty. Dec. LEXIS 196 at *21 (Clearfield CCP Dec. 20, 2001) (“failure to read documents ... does not support a cause of action for reformation”).

Affirmative lender liability claims may also arise involving assertions that the lender breached implied warranties of good faith and fair dealing by:

- Improperly stopping funding or draws
- Promising to provide additional funds but failing to do so
- Inducing the borrower to take actions harmful to its interest
- Misrepresenting intentions about the loan or anticipated extensions
- Providing inadequate notice of intended actions or default
- Making false promises
- Taking action on immaterial defaults

In addition, there are well-defined duties that a mortgagee-in-possession owes to a mortgagor. The mortgagee-in-possession must account for rents and profits, maintain the mortgaged premises in good condition to avoid deterioration, and may be liable for waste. See *Landau v. W. Pa. Nat’l Bank*, 282 A.2d 335, 339 (1971).

Nonetheless, the Pennsylvania Supreme Court “has refused to impose a duty of good faith which would modify or defeat the legal rights of a creditor.” *Creeger Brick & Bldg. Supply, Inc. v. Mid-State Bank & Trust Co.*, 560 A.2d 151, 154 (Pa. Super. 1989). Thus,

a lending institution does not violate a separate duty of good faith by adhering to its agreement with the borrower or by enforcing its legal and contractual rights as a creditor. The duty of good faith imposed upon contracting parties does not compel a lender to surrender rights which it has been given by statute or by the terms of its contract. Similarly, it cannot be said that a lender has violated a duty of good faith merely because it has negotiated terms of a loan which are favorable to itself. As such, a lender generally is not liable for harm caused to a borrower by refusing to advance additional funds, release collateral, or assist in obtaining additional loans from third persons. A lending institution also is not required to delay attempts to recover from a guarantor after the principal debtor has defaulted. Finally, if the bank in this case falsely represented appellants’ financial circumstances to other creditors for the purpose of damaging appellants’ ability to continue doing business, appellants may have causes of action in tort for slander, misrepresentation, or interference with existing or prospective contractual relations. There is no need in such cases to create a separate tort for breach of a duty of good faith.

Id.; see also *Rearick v. Elderton State Bank*, 97 A.3d 374 (Pa. Super. 2014) (a lender who refused to restructure debt to benefit the plaintiff did not breach any duty). See also *Angino & Rovner, P.C. v. Sovereign Bank, N.A.*, No. 13-1563, 2014 Pa. Dist. & Cnty. Dec. LEXIS 970 at *8 (Berks CCP May 14, 2014) (“bank may refuse to extend credit or modify a loan if it wishes to do so”).

Assignment of Leases and Rents

An assignment of leases and rents secures the lender’s interest in the income that the property’s leases generate. The parties can either incorporate the assignment provisions into the mortgage or prepare a separate agreement. The assignment may be absolute, which conveys the leases and rents to the lender who has immediate, direct control over rents, or collateral, which grants a lien on leases and rents to the lender. An absolute assignment may provide the lender with greater protections than a collateral assignment, including priority over intervening creditors in bankruptcy. Note that depending on the terms of the agreement, the lender may need to take physical possession of the premises and notify tenants to redirect rental payments from the borrower to the lender.

For further guidance on assignments of leases and rents, see [Assignment of Leases and Rents in a Commercial Real Estate Loan Transaction](#). For an assignment of leases and rents template to use in your acquisition financing transaction, see [Assignment of Leases and Rents \(Acquisition Loan\)](#).

Deed in Lieu of Foreclosure

A deed in lieu of foreclosure is a deed instrument that transfers title from the borrower to the lender or its assignee in lieu of the completion of a foreclosure. This arrangement allows the borrower to satisfy the defaulted loan and exchange mutual releases with the lender through a companion settlement agreement. Note, however, that the borrower may remain liable for a remaining amount due. See *PNC Bank, Nat’l Ass’n v. Balsamo*, 634 A.2d 645, 656 (1993). The lender typically takes title in the name of an affiliated special purpose entity to protect the lender from property-specific liability. This is a way to short-circuit the longer and more costly foreclosure and sheriff’s sale route.

Lenders should be aware that, unlike a foreclosure, a deed in lieu does not eliminate junior liens, such as judgments, junior mortgages, or mechanic’s liens. Therefore, if the lender decides to proceed with a deed in lieu, it should require that the property have clear title (i.e., the absence of other liens). Clear title permits the lender to acquire the property without the risk that other creditors will become priority lienholders. If the process is relatively amicable, the parties may stipulate to a foreclosure judgment, which would allow for the sale of the property through the sheriff’s sale while expediting the process.

Receiverships

A lender may ask a court to appoint a receiver to take possession of the borrower’s assets, books and records, and management of the business on an interim basis to preserve the status quo and avoid waste until the parties resolve an action for final relief, such as foreclosure.

Pa. R.C.P. 1533 and 1007 provide the process for the appointment of a receiver. Note that the lender must present sufficient facts to permit the appointment, such as the prevention of waste or injury or the avoidance of fraudulent transfers and nefarious conduct. See *Hankin v. Hankin*, 493 A.2d 675, 679 (1985); *Landau v. W. Pa. Nat’l Bank*, 282 A.2d 335, 339 (1971). A federal court sitting in diversity must apply federal law when determining whether to appoint a receiver. *Midwest Bank v. Goldsmith*, 467 F. Supp. 3d 242, 248 (M.D. Pa. 2020).

“[T]he form and quantum of evidence required on a motion requesting the appointment of a receiver is a matter of judicial discretion.” *Wright & Miller, Federal Practice and Procedure Civil* § 2983.

Although there is no set formula for determining when a receiver should be appointed, a federal court should consider the following factors in conducting such an analysis:

- The probability of the plaintiff’s success in the action
- The possibility of irreparable injury to the plaintiff’s interests in the property
- The inadequacy of the security to satisfy the debt
- The probability that fraudulent conduct has occurred or will occur to frustrate the plaintiff’s claim
- The financial position of the debtor
- The imminent danger of the property being lost, concealed, injured, diminished in value, or squandered
- The inadequacy of available legal remedies
- The lack of a less drastic equitable remedy
- The likelihood that appointing a receiver will do more harm than good

See *Midwest Bank v. Goldsmith*, 467 F. Supp. 3d 242, 248 (M.D. Pa. 2020)

The decision to appoint a receiver is an equitable one available at the court’s discretion. The court must consider whether, among other factors:

- Milder measures will give the plaintiff adequate protection
- Legal remedies appear inadequate
- There continue to be “fraud or imminent danger of the property being lost, injured, diminished in value, or squandered”

- There has been “a showing that the harm accruing to plaintiff by denial clearly overbalanced the harm to defendant upon granting the appointment”

KeyBank Nat'l Ass'n v. Fleetway Leasing Co., 2019 U.S. Dist. LEXIS 177015, at *26-27 (E.D. Pa. Oct. 11, 2019) (internal citations omitted); see also KeyBank Nat'l Ass'n v. Fleetway Leasing Co., 781 Fed. Appx. 119 (3d Cir. 2019). Proof of fraud is not required, but will support a court's decision to appoint a receiver. Keybank, 2019 U.S. Dist. LEXIS at *27 (citing Aviation Supply Corp. v. R.S.B.I. Aerospace, Inc., 999 F.2d 314 (8th Cir. 1993)).

The loan agreement may also provide for a receiver in certain circumstances, which the court may consider as an additional factor. See Metro. Life Ins. Co. v. Liberty Ctr. Venture, 650 A.2d 887, 891 (1994). “Although a nonmovant's consent to the appointment of a receiver weighs heavily in favor of appointment of a receiver, the ultimate decision of whether to appoint a receiver is left to the discretion of the district court.” Midwest Bank v. Goldsmith, 467 F. Supp. 3d 242, 251 (M.D. Pa. 2020).

A central “purpose of equity receiverships is to promote orderly and efficient administration of the estate by the district court for the benefit of creditors.” SEC v. Hardy, 803 F.2d 1034, 1038 (9th Cir. 1986). The Third Circuit has long held that a court sitting in equity may authorize a receiver to sell estate assets free and clear of liens and other claims. See People's-Pittsburgh Tr. Co. v. Hirsch, 65 F.2d 972, 972 (3d Cir. 1933); Miner's Bank of Wilkes-Barre v. Acker, 66 F.2d 850, 853 (3d Cir. 1933). Federal courts overseeing receiverships have repeatedly reaffirmed this principle. See, e.g., SEC v. Capital Cove Bancorp LLC, 2015 U.S. Dist. LEXIS 174856, at *13 (C.D. Cal. Oct. 13, 2015); Regions Bank v. Egyptian Concrete Co., 2009 U.S. Dist. LEXIS 111381 (E.D. Mo. Dec. 1, 2009).

Free-and-clear sales of receivership assets that will not satisfy debts to secured creditors are generally disfavored because creditors may sometimes achieve more significant recoveries through their own foreclosure efforts. There is no outright ban on the practice, however, which would deprive courts of the flexibility essential to administering a receivership estate. Accordingly, whether to allow such sales usually turns on the facts of the case. See Spreckels v. Spreckels Sugar Corp., 79 F.2d 332, 334 (2d Cir. 1935); see also Capital Cove, 2015 U.S. Dist. LEXIS 174856; Clark, Treatise on the Law and Practice of Receivers § 500(c). Courts have repeatedly ruled that whether to authorize free-and-clear sales that will not generate a surplus is a matter of the district court's equitable discretion. See, e.g., People's-Pittsburgh Trust Co., 65 F.2d 972.

The court has discretion on how to pay the receiver's costs and “it is but right and fair that” those who benefit from the Receiver's activities “should be required to pay [their] burden

of the costs, including allowances to the [R]eceiver.” Clark, Treatise on the Law and Practice of Receivers § 638; see also Ratner v. Iron Stone Real Estate Fund I, L.P., 2021 Pa. Super. LEXIS 677 (Nov. 19, 2021). Note that courts generally lack the power to charge lienholders for expenses associated with “improving or making additions to the property or carrying on the business of the defendant at the expense of prior mortgagees or lienholders without the sanction of such mortgagees or lienholders” but lienholders may be charged for reasonable expenses “absolutely necessary [for] preservation of the property.” Clark, Treatise on the Law and Practice of Receivers § 638.

Security Interest in Personal Property Collateral

The loan agreement may provide a security interest in personal property collateral related to the real property. Article 9 of the Uniform Commercial Code sets forth the process to perfect and maintain a security interest in personal property, including through a properly filed UCC-1 financing statement. See 13 Pa. Cons. Stat. Ann. §§ 9101–9110. The lender must file a UCC-3 continuation statement no more than six months before the expiration of the initial five-year period or any later five-year period.

For further guidance on preparing and filing UCC financing statements in Pennsylvania, see [Foreclosure of Real Property](#).

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