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Lender Beware Upstream vs. Downstream Guarantees

By

In the world of commercial finance, many loans are secured by real estate; the borrower gives the lender a lien on the borrower's real estate to secure payment of the loan. In Maryland, the downside to granting this type of lien is the large amount of taxes collected by the clerk of court when the lien is recorded. On a loan of $1 million, for example, the taxes collected could easily exceed $10,000. Loans running in the many millions of dollars are not uncommon and they can cost the borrower hundreds of thousands of dollars in taxes collected when the lien is recorded.

To avoid these high taxes, many borrowers in Maryland (with the lenders' approval) have resorted to the use of Indemnity Deeds of Trust or Indemnity Mortgages, known in the industry as "IDOTS." The recording of an IDOT in the county land records creates the lien on the real estate. In most but not all counties in Maryland, and for reasons which are not easily explained, IDOTS can be recorded without the payment of any taxes. A company seeking a loan, - whether $2 million or $200 million – to be secured by real estate, can, in most Maryland counties, avoid all of these taxes through the use of the IDOT. How is this possible - and legal? What happens is that the loan is made to a shell company, the stock of which is wholly owned by the parent company. In turn, the parent company guarantees payment of the loan and secures its guaranty with an IDOT t, which is then recorded by the clerk of the court without the payment of any taxes. In the league of loopholes, this is major league!

In the scenario just outlined, the lender ends up with what it wanted–a nice loan secured by valuable real estate. Yet there remains a potential problem for the lender if the loan is not properly structured. Let's say the company which owns the real estate and which granted a lien to the lender falls on hard times and ends up in bankruptcy. The creditors of that company could possibly succeed in getting the bankruptcy court to set aside the lien on the grounds that the granting of the lien to the lender was a "fraudulent conveyance," which would turn the lender into an unsecured creditor, clearly a bad thing for the lender.

Without getting into a whole discussion of fraudulent conveyances, suffice it to say that under the Federal Bankruptcy Code, if the company which granted the lien is found to have received less than "reasonably equivalent value" in exchange for the lien, then it could be set aside by the bankruptcy court. The same is true under the Maryland Uniform Fraudulent Conveyances Act, except the test under the Maryland statute is whether the company which granted the lien received "fair consideration" in exchange for the lien. While there is a difference between "reasonably equivalent value" under federal law and "fair consideration" under state law, for purposes of this paper we will assume that they have substantially the same meaning.

Here is where it is important for the lender to distinguish between the downstream guarantee and the upstream guarantee. If the IDOT loan is structured as a downstream guarantee, bankruptcy courts will generally uphold the lien. If the IDOT loan is structured as an upstream guarantee, bankruptcy courts will generally set aside the lien as a fraudulent conveyance. The rationale for upholding a lien created with a downstream guarantee is that the grantor of the lien (the parent company as guarantor of the loan) owns 100% of the stock of the borrower and, as such, the cash infused into the borrower (the parent's wholly owned subsidiary) is a sufficient benefit to the parent so that it equates to "reasonably equivalent value" received by the parent in exchange for the lien granted by the parent to the lender.

However, in an upstream guarantee, the loan is made to the parent. The loan is then guaranteed by the subsidiary, which grants a lien to the lender on the subsidiary's real estate. If the subsidiary becomes the subject of a bankruptcy proceeding, it is more likely than not that the bankruptcy court would set aside the lien as a fraudulent conveyance, finding that the subsidiary, which owns no stock in the parent, gave away its real estate to guarantee the parent's loan but did not receive "reasonably equivalent value" in return, creating a classic fraudulent conveyance.

A lender that agrees to accommodate its borrower through the use of IDOTS to avoid the heavy-duty recordation taxes in Maryland must understand, prior to making the loan, whether the transaction amounts to an upstream guarantee or a downstream guarantee. If it's the former, the lender runs a great risk that upon the bankruptcy of the subsidiary (the grantor of the lien), it is likely that the bankruptcy court will set aside the lien, leaving the lender in the undesirable position of being an unsecured creditor.