Kilborn’s “Collateral Mortgage Packages” Problems

You are the junior associate in a large firm representing Bank One on a large financing deal. Duhe Drilling Company (“DDC”) has arranged for Bank One to make available to it a $10 million line of credit. Under the line of credit arrangement, DDC will take loans from Bank One from time to time, generally between $1 million and $2 million at a time as needed, to fund its exploration and drilling operations, and it will pay interest only on amounts actually outstanding at any given time. The line of credit agreement says that Bank One agrees to make certain future loans without the need for a separate and additional loan application and approval process for each future loan. DDC can borrow and repay loans of any amount under the line of credit arrangement as often as it wants, but the total amount of loans outstanding can never exceed $10 million (plus interest calculated at LIBOR plus 250 basis points—a concept which the partner says you need not understand). Duhe has agreed to grant Bank One a mortgage in several tracts of immovable property that it owns to secure any loans outstanding under the line of credit arrangement at any given time.

Guided by the senior partner’s instructions and the firm’s form files, you prepared four documents for DDC’s president to sign at the closing on this deal:

(1) a document captioned “Collateral Mortgage Note” that reads in its entirety as follows: “Duhe Drilling Company, for itself and on behalf of its successors and assigns, hereby promises unconditionally to pay upon demand to the order of BEARER the sum of $15 million (fifteen million U.S. dollars), plus interest calculated at LIBOR plus 250 basis points for every day or portion of any day following the date of this Collateral Mortgage Note that has passed before payment in full of all obligations represented by this Collateral Mortgage Note.”

(2) another very similar document captioned “Hand Note,” in which DDC promises to pay to the order of Bank One $2 million plus interest in 60 equal monthly installments, commencing two months from now and ending five years later.

(3) a document captioned “Collateral Pledge Agreement,” in which DDC recites that it is transferring possession of the Collateral Mortgage Note to Bank One to secure any and all indebtedness by DDC to Bank One of any kind, whether related to the line of credit arrangement or not, arising at any point in the past, present, or future.

(4) a document captioned “Collateral Mortgage,” in which DDC grants a mortgage in several properly described tracts of immovable property owned by DDC to secure any and all indebtedness by DDC under the Collateral Mortgage Note, up to its stated maximum.

A mid-level associate at the firm explains to you that there is a much easier way to document this transaction, but the senior partner in charge of the deal is known to be extremely conservative and “old-fashioned.”

You are the only lawyer from your firm assigned to be present at the closing for this transaction. How do you deal with the following “issues” that arise during the closing:

A. Just as she is about to sign the first document (the “Collateral Mortgage Note”), DDC’s president turns to you and says the following: “We’re only borrowing $2 million at first here under the line of credit, we’re promising to repay it over time, not on demand, and we’re promising to pay Bank One, not just anyone who happens to get ahold of the note. And I see that I will sign another
note in which we actually promise to pay Bank One the $2 million that we’re borrowing. What’s up with this?” Is DDC really undertaking immediate personal liability on the entire $15 million Collateral Mortgage Note in addition to the $2 million Hand Note? If not, what law can you cite to give DDC’s president assurance that DDC is NOT immediately obligated to pay the $15 million to anyone who comes into possession of the Collateral Mortgage Note?

B. The Bank One executive at the closing then turns to you and notes that the first $2 million of payments from DDC will be credited only to the Hand Note, not to the Collateral Mortgage Note. Since the Hand Note will be paid over five years, and an obligation represented by a note prescribes in five years, she asks if the Collateral Mortgage Note will prescribe by the time the Hand Note is paid (the Collateral Mortgage Note is “exigible” immediately, she observes). She is concerned because, if the Collateral Mortgage Note prescribes, the Collateral Mortgage will be extinguished, and the entire deal will be destroyed. What, if anything, will prevent prescription of the Collateral Mortgage Note if DDC makes no payment on it?

C. The notary at the closing is relatively inexperienced. She explains that she learned that every note secured by a Collateral Mortgage must be paraphed “ne varietur” for identification with the mortgage. She’s not sure whether this rule applies here, and if so, which note (the Collateral Mortgage Note or the Hand Note) should be paraphed, or both. What do you say?

D. Finally, after all of the paperwork is signed, and everyone is ready to leave, the Bank One executive pulls you to the side and asks the following question: Even if DDC is not personally obligated on the Collateral Mortgage Note, the documents say that Bank One has a mortgage to secure the $15 million Collateral Mortgage Note. Right now, if DDC were to default on the $2 million Hand Note and the $15 million Collateral Mortgage Note, could Bank One foreclose on the mortgaged immovable property and collect $15 million from the foreclosure sale proceeds?