

# Robbins, Salomon & Patt, Ltd.

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## THE MORTGAGE FORECLOSURE CRISIS: *How did we get to where we are and where are we going?*

If you have been reading the newspapers, listening to talk radio or watching the TV news, you have become both acutely aware and often immune to terms such as “mortgage foreclosure crisis,” “predatory lending,” “subprime loans,” and “adjustable rate mortgages (ARMS).”

The problem has many faces and can be looked at from different viewpoints. Let’s clarify some misconceptions and shed some light on understanding the problem. The efforts presently underway through legislative, judicial and political action to solve the problem do not always reflect an understanding of the issues and causes. In attempting to clarify these issues, we would like to focus on some basic areas.

### **Subprime Loans**

Subprime loans are loans that are more risky and less than ideal as compared to conventional standards, because the borrowers are less credit worthy. Loans of this type have been around for a long time. Until recently, they were made by what was known as the secondary market.

Until a few years ago, the conventional primary market turned down loan applicants who were less likely to repay loans and who would have difficulty paying for the charges related to the added risk. In recent years, primary market lenders undertook subprime loans in order to take advantage of the fees generated by such loans and the high volume of business available.

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There always has been and always will be a higher rate of defaults and delinquencies in subprime loans, because these borrowers can least afford to repay. Defenders of subprime loans argue these loans have enabled many people to purchase homes who would otherwise not be able to do so. Reputable studies estimate performing subprime loans at above 80%. This lends credibility to the point that many people have been able to buy homes who otherwise could not have done so. However, the impact of the large number of defaulted and foreclosed mortgage loans (the 20% who do not make their payments) is being felt in ways never anticipated.

### **The High Cost of Foreclosures**

The number of foreclosure activities nationwide doubled from the end of 2006 to the end of 2007 and again in 2008. Wealthier areas are setting new records for foreclosure lawsuits. The problem has clearly not peaked. In this mortgage foreclosure crisis nobody wins. While the full impact has yet to be realized, the costs of foreclosure are known and are enormous.

The major costs incurred by a borrower whose mortgage loan is foreclosed include the following: Loss of the housing asset. Loss of the down payment and loan principal paid by the borrower. Penalties and finance charges levied by the mortgage lender or servicer over the period that the borrower is in delinquency. Legal fees associated with the foreclosure process. Taxes on the amount of forgiven debt. Negative credit impact. Moving expenses. Psychological and physical effects.

The major costs incurred by the mortgage lender or servicer include: Loss of the loan principal, equal to the difference between the outstanding mortgage debt and the foreclosure sale price. Increased servicing expenses. Legal fees associated with the foreclosure process. Property maintenance costs. Utilities. Real estate taxes. Insurance costs. The total loss to a lender in the event of a foreclosure has been reported to be as much as 40%.

### **Refinancing**

A huge volume of refinancing pushed by aggressive mortgage brokers and unwise borrowers – even those who qualified for conventional loans – has added to the problem. Refinancing makes sense when interest rates

fall or when a homeowner has incurred an extra ordinary non-recurring expense. However, many homeowners gave in to the temptation to refinance multiple times, using their equity to pay for non-essentials.

The premise that home values would increase forever did not hold up, leading to mortgage debt often being greater than the home's worth. The problem is further compounded by an inability to pay mortgages when they mature on short-term adjustable rate terms. As the adjustable rate mortgages increase or become due, homeowners are finding they are unable to keep up with their mortgage payments.

### **Shared Responsibility**

Overly aggressive mortgage brokers, unwise borrowers, reckless lenders and reckless investors have all contributed to the current problem. Some lenders extended credit without requiring down payments or proof of the borrower's ability to repay the loan. This produces no benefit to the borrower or the ultimate holder of the mortgage debt. No one is blameless.

### **What Can Be Done?**

The difficult solution will require dialogue and reasonable negotiations between lenders and borrowers, including loan modifications and forbearance agreements. Lenders will look to add the borrower's arrearage onto the back end of the loan, in the nature of a balloon payment. There will need to be extensions of loans beyond customarily used amortization periods, modifications of interest rates, and realistic adjustments of expectations by both lenders and borrowers.

Borrowers will have to adjust the prevailing sense of entitlement from a standard of living they cannot afford. Lenders have to recognize their role in this mess and be prepared to mitigate their damages, with the understanding that the legal system will not provide a solution that makes them whole. The process will require patience and will test American resiliency in ways we have not seen for decades.

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## THE PHANTOM STOCK EQUITY PLAN: A WAY TO RETAIN KEY EMPLOYEES... WITHOUT GIVING THE COMPANY AWAY.

Business owners often ask, "How can I reasonably compensate my key employees and continue to motivate them without making them co-owners of my company?"

One workable solution is to create a Phantom Stock Equity Plan. This is a compensation tool designed to motivate and retain key employees, without an actual transfer to them of an equity interest in the company. The issuance of phantom stock provides a method for a company to grant its key employees a bonus (phantom stock or cash) if the company meets defined financial goals or when a particular event occurs, such as a sale or refinancing of the company, without incurring the risks and complications that accompany the issuance of stock to a minority shareholder.

What's wrong with issuing stock to a minority shareholder? A lot. Every equity owner, even one that owns a very minor interest in the company, has certain rights, including the right to receive notice of meetings, the right to vote and the right to inspect the books and records of the company. Also, the officers and directors of the company owe the minority owner certain fiduciary duties.

On the other hand, these rights and certain fiduciary duties can be very limited for the holders of phantom stock.

Under the terms of a Phantom Stock Equity Plan, the employer issues the key employee a set number of shares of phantom stock. The phantom stock is not actual equity in the company, but is tied to the value of the company's stock or its annual profitability. The employer states in the plan a formula to determine the value of the phantom stock and the events that would give rise to a distribution of money to the phantom equity owner.

If the plan is structured to reward the key employee upon a defined event, the plan can contain restrictions relating to the distribution, such as the right to share in the

proceeds of the sale of the business in excess of a certain threshold amount. For example, the threshold amount established in the plan may reflect the value of the business as of the effective date of the plan, thereby rewarding the key employee for any growth after that date. When the payout occurs, it is taxed as ordinary income to the employee and is deductible to the employer.

The plan can be drafted to require the employee to be vested, in whole or in part, in order to be eligible to receive distributions. That means that the employee would have to be employed by the company for a certain number of years and still be employed at the time of the distribution. If the employee is terminated, the phantom stock may be forfeited and the employee may no longer be entitled to any money.

If an employee is a true shareholder of the company (rather than a holder of phantom stock), the shareholder continues to own shares of the company even after his employment is terminated and will remain entitled to any equity distribution. In addition, the officers and directors of the company have continued fiduciary obligations to the equity owner, even after the termination of employment.

For closely held companies that want to offer their key employees the ability to share in the company's success without diluting their control and equity interest in the company, a carefully crafted Phantom Stock Equity Plan offers maximum flexibility. The company can design creative measuring criteria and vesting schedules that help retain key employees and help align the employee's interests with those of the company. The company can also offer bonus compensation to its key employees without the burden of the obligations owed to an equity owner.

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## NAVIGATING SUBCONTRACTOR MECHANICS LIENS

As the business cycle slows, using various legal tools to collect payments due becomes more and more important. For construction subcontractors, enforcement of a mechanics lien can be a powerful collection device.

The Illinois Mechanics Lien Act generally allows any person who provided labor, materials, equipment or services to improve real estate to record a lien against the property to enforce payment. Strict compliance with the terms of the statute is crucial. A subcontractor who does not specifically follow the letter of the law risks losing all lien rights. To complicate matters, subcontractors' liens are twice as involved as are general contractors' liens.

Any entity that makes a contract directly with the owner of the real estate is considered a general contractor. Any entity that does not enter into a contract directly with the owner is considered a subcontractor. Thus, if a tile supplier enters into a contract directly with the property owner, the tile supplier is a general contractor. If he makes a contract with a general contractor or construction manager or anyone who is not the owner, he is a subcontractor.

### Notice to Owners – Non Residential

If the subcontractor is not being paid, he must send a notice, via certified mail or personal delivery, to the owner stating that the subcontractor performed work on the property and the amount of the subcontract for that work. The notice can be sent anytime after making the contract to perform construction, but not less than 90 days after the last day of work.

### Notice to Owners – Residential

In addition to the 90 day notice, just to make things more difficult, a subcontractor must send another notice to the owner of an existing owner-occupied, single family residence. This notice must be sent with 60 days of when the subcontract first started work or supplied materials.

Any subsequent lien a subcontractor may file is still valid against an owner of a single-family owner-occupied existing residence. However, the owner can argue that the subcontractor's lien should be reduced by the amount the owner was prejudiced by payments made prior to the owner's receipt of the 60 day notice.

### Sworn Statements

The general contractor is required to provide a written sworn statement to the owner listing the names and addresses of all parties furnishing materials and labor and the amounts due to each. To protect those claiming a lien, so that the owner can not plead ignorance, the law places on the owner an affirmative duty to require sworn statements from the general contractor.

If the subcontractor is named on a sworn statement, the subcontractor need not send the 90 day notice of his lien. However, if the subcontractor relies on a sworn statement and does not send his own notice to the owner, the subcontractor can only claim the dollar amount stated on the sworn statement.

If a lien is filed, an owner that pays in good faith reliance on the amounts set forth in the contractor's sworn statement is not liable for any amount in excess of the amount stated on the sworn statement, regardless of whether that amount is correct.

To make certain the amount is correctly stated, as part of the subcontractor's contract with the general contractor, the subcontractor should have the right to review and approve all sworn statements submitted to the owner.

### Perfecting the Lien

A mechanics lien is enforceable only if it is properly perfected. That means yet another procedural step must be followed. All liens under the Mechanics Lien Act must be filed within four months of the date of last work to prevail against the owner and any third parties. A mechanics lien can be filed up to two years before the last day of work, but will only be enforceable against the owner if it is filed after the four months.

However, a subcontractor cannot perfect its lien without properly sending out its 90 day notice. Due to the importance of the 90 day notice, subcontractors should record the lien and send the lien via certified mail within 90 days of last work.

The date of last work – when the time starts to run to send the 90 days notice and record the mechanics lien – is not simple punch list work or a date in which the

subcontractor happened to be at the job site. The date of last work is the date when the subcontractor performed some substantial work in furtherance of the contract, and is expressly not considered mere punch list work.

Another example of the complexity of a subcontractor's mechanics lien is that a subcontractor cannot simply look to the language of the statute to know what must be said in the filed lien. The lien must state the date of the contract and the date of last work but the statute does not say that.

#### **Foreclosure of the Lien**

After the lien is recorded, the subcontractor has two years from the date of last work to sue in court to foreclose the lien. If suit is filed and a judgment is entered against the owner on a lien claim, the owner will be liable for no more than the amount that was due from the owner on the underlying owner/contractor agreement at the time the owner received notice of the subcontractor's claim.

If there is more than one subcontractor lien claim, then each will recover pro rata. This recovery is subject to the defense that if an owner pays in reliance on a sworn

statement, the owner will not be liable for any amount in excess of the amounts shown on the sworn statement.

#### **Priority Over Motgages**

The date on which a subcontractor's mechanics lien attaches is the date of the contract between the owner and the contractor. It is this date that determines the priority of the lien relative to other claimants or creditors secured by the real estate. This feature of the Mechanics Lien Act, that allows a lien claimant's lien right to attach to the real estate as of the date of the general contract (and not the date of recording), may allow mechanics lien claimants to come ahead of previously recorded mortgages if the general contract predates the recording date of the mortgage.

This is only a general summary of some aspects of the mechanics lien law. Those unfamiliar with the working of this statute should proceed with the utmost caution. The waters here are full of sharks, most of whom have not had a decent meal for months.

*\* Andrew M. Sachs &  
Larry N. Woodard*

## IN MEMORIAM

### **James M. DeZelar**

The attorneys and staff of Robbins, Salomon & Patt, Ltd. regret to announce that our friend and partner Jim DeZelar died unexpectedly on December 7, 2008.

Jim joined the law firm as a young litigator in 1977, after serving for several years as an attorney at the Chicago Legal Assistance Foundation. The partners immediately took notice that Jim was an exceptionally gifted lawyer. The word around the office was that Jim was capable of litigating the most complex of cases. He soon became the go-to guy in commercial litigation.

Jim had a unique ability to synthesize the facts of a case, frame the issues and present them in court in the most compelling way. His legal briefs were a model of clarity and persuasiveness. Jim was a mentor to young lawyers when they joined the firm as well as to a legion of law students who worked at the firm as law clerks over the years, serving as their confidant, sounding board and trusted friend.

Though an intensely private man, we knew Jim as a loving father, devoted to his family's welfare. Jim, our friend and colleague, you will never be forgotten.



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WORDS TO LIVE BY

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The difference between genius and stupidity is that genius has its limits.

GREAT URBAN LEGENDS OF THE LAW

*Fact or Fiction?*

You cannot sue a minor.

**A: Mostly fiction.**

*The age of majority (legal adulthood) in Illinois is 18 years. Prior to his 18<sup>th</sup> birthday, a person is a minor. No law prohibits suing a minor because of his negligence or carelessness.*

*Indeed, in Illinois, as in many states, a person is required to behave like an adult beginning with his 14<sup>th</sup> birthday. Going even further, Illinois law says that commencing on his 7<sup>th</sup> birthday, a child can be sued, although from ages 7 to 14 he is held only to the standard of a child of the same age and experience.*

*The 7<sup>th</sup> birthday is where Illinois draws the line: a child below 7 years is deemed incapable of negligence and therefore cannot be sued. Appelhans vs. McFall, 325 Ill.App.3d 232.*

*So, you cannot sue a child younger than 7, but who would ever want to? Really, how much damage can a 6 year old do?*

## NEW ATTORNEYS AT RSP

**We are pleased to announce that three attorneys have joined Robbins, Salomon & Patt.**

**Arthur Radke** is an experienced trial attorney whose practice focuses on business litigation and dispute resolution. He represents a wide variety of business and financial institutions and is licensed to practice law in both Illinois and Wisconsin.

**Robert Trizna** is a seasoned litigator who has represented a diverse group of national and international businesses and small and medium sized companies for over 30 years.

**Vitaly Gashpar** is a recent law school graduate who passed the Illinois bar exam and now begins his career in the law as an associate with Robbins, Salomon & Patt. He recently served as a judge in an international moot court competition among law students.

## RECENT ANNOUNCEMENTS

**All the news you can use...**

ACHIEVEMENTS OF NOTE

**Andy Lapin** was honored by Chicago Magazine as an "Illinois Super Lawyer of 2009" in the field of corporate law. He was also recognized by the Illinois Leading Lawyers Network as an outstanding attorney in commercial law and privately held business law.

**Kymn Harp** authored a new book: *Intent to Prosper – Commercial Real Estate*. Two articles by Kymn on loan workouts were published by First American Title Insurance Company in its *Insight* magazine.

**Larry Woodard** authored an article on bulk sales liability in real estate transactions for the Illinois State Bar Association's real property newsletter.

**Bob Winter** authored an article on evidence for the Chicago Bar Association's tort litigation newsletter.

**Tracy Stevenson** chaired the Illinois Defense Council's 20<sup>th</sup> annual course on trial techniques for attorneys and authored a column in *IDC Quarterly* magazine.

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